S. HRG. 102-68 PT. 1

CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1992

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

JANUARY 23, 1991—ECONOMIC AND BUDGET OUTLOOK

FEBRUARY 5, 1991—CONSIDERATION OF THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1992

FEBRUARY 6, 1991—CONSIDERATION OF THE ECONOMIC OUTLOOK AND THE FISCAL YEAR 1992 BUDGET

Part 1 of 5

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CONTENTS

HEARINGS

	Page
January 23, 1991—Economic and Budget Outlook	1
February 5, 1991—Consideration of the President's Budget for Fiscal Year 1992	131
February 6, 1991—Consideration of the Economic Outlook and the Fiscal Year 1992 Budget	221

STATEMENTS BY COMMITTEE MEMBERS

Chairman Sasser	1, 131, 221
Senator Domenici	3, 133, 223
Senator Kasten	6, 191, 284
Senator Symms	5

WITNESSES

Bergsten, C. Fred, director, Institute for International Economics	70
Boskin, Dr. Michael J., chairman, Council of Economic Advisers	238
Brady, Hon. Nicholas F., Secretary of the Treasury	225
Darman, Hon. Richard G., Director, Office of Management and Budget	135
Friedman, Benjamin, professor, department of economics, Harvard University	52
Levy, Mickey D., chief economist, CRT Government Securities, Ltd	85
Reischauer, Robert D., Director, Congressional Budget Office	6

ADDITIONAL MATERIAL

Q. and A.—Committee members to witnesses, written:	
Dr. Boskin	285
Secretary Brady	286
Mr. Darman	191

ECONOMIC AND BUDGET OUTLOOK

WEDNESDAY, JANUARY 23, 1991

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:08 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Jim Sasser (chairman of the committee) presiding.

Present: Senators Sasser, Hollings, Exon, Lautenberg, Simon, Wirth, Conrad, Domenici, Symms, Grassley, Kasten, and Nickles.

Staff present: Larry Stein, staff director; John J. Callahan, deputy staff director; and Alan Cohen assistant director for budget priorities and review.

For the minority: G. William Hoagland, staff director; and Peter Taylor, chief economist.

OPENING STATEMENT OF CHAIRMAN SASSER

Chairman SASSER. The committee will come to order.

I want to welcome everyone before the Budget Committee this morning. I want to welcome our distinguished committee members to this, our first hearing of this session, including our distinguished ranking member, Senator Domenici. We are pleased to have him back after a successful re-election campaign last year, and our distinguished chairman emeritus, Senator Hollings of South Carolina, and I want to welcome also Senator Exon and Senator Simon, both back after fresh renewals on the part of the electorate of their State. I want to congratulate them on their very successful re-election campaigns. Of course, we are always pleased to see our friend from North Dakota, Senator Conrad, here this morning.

Today the Senate Budget Committee begins its hearings on the 1992 budget which will be submitted to the Congress on February 4th. Of course, it goes without saying that these are days of great apprehension and anxiety for our whole country. Our thoughts and prayers are with our countrymen who this morning are in Saudi Arabia. We all pray for their safety, for their success, and for their quick return.

With those thoughts uppermost in our minds, however, we do have responsibilities that continue here at home. Indeed, some of the projections and judgments that we will hear in this room today may well be affected by events as they unfold in the Middle East. There are matters before us that we simply cannot ignore, and these hearings will be about some of the most crucial of those.

Last October, the Congress passed and the President signed into law a 5-year, $500 billion deficit reduction package. I am fond of

saying, I say to my friend, Senator Domenici, that prior to the enactment of that package, all of the public opinion polls were indicating that the most important issue to be resolved as far as the American people were concerned was dealing effectively and meaningfully with the budget deficit. Congress and the administration sought to do that together, and following the result of that action, the President fell 20 points in the public opinion polls and anti-incumbent fever swept the country, partly as a result, I think, of the budget agreement, and there were calls for the resignation of the Director of the Office of Management and Budget, Mr. Darman, even from within his own party.

So what I think that means is that we fashioned a meaningful deficit reduction agreement that really reduced the deficit, that really caused some pain, that really drew some blood. So, as a result of that, I think there was widespread unhappiness with it.

Now, this is the largest deficit reduction package that has ever been enacted in the history of this Republic. While war in the Persian Gulf and recent downward developments in the economy have overshadowed the October agreement, economists of all stripes, liberal and conservative, of all partisan persuasions, Democratic and Republican economists, have noted that there are basic strengths in this agreement.

Moreover, the Congressional Budget Office has noted that if this agreement holds, the unified deficit may be less than 1 percent of GNP by 1995, and that will be the lowest level since 1974.

So it is clear that we have fashioned an effective deficit reduction package and that we must abide by it in order to sustain future economic growth.

But I think it is equally clear that a lot of the good work that we put into this agreement is now being overtaken by a slowing economy, by a weakened banking structure, and by our fiscal obligations to the military operations in the Middle East.

By some indication, then, estimates of the 1991 deficit have increased by over $50 billion just since last October when we finalized the deficit reduction agreement.

So I think we can draw two conclusions from these developments.

First, I draw the conclusion that we must maintain our deficit agreement, that we should guard against going back on it, that we must have the close to $500 billion in deficit reduction delivered by that agreement if we are to restrain spending and if we are to ensure future prosperity.

Second, while the Congressional Budget Office Director, Dr. Reischauer, will today certify that we are in a recession, I intend to oppose any suspension of the Budget agreement or any suspension of the Gramm-Rudman-Hollings Act as a result of this certification.

To suspend the budget accord now would be counterproductive, in my judgment. It would negate the 5-year structure of the plan and tell the American people that we simply are not serious about reducing the deficit.

Ironically, suspending the Gramm-Rudman-Hollings enforcement mechanism might well close off the one route that we have open to us to escape from this recession, and that is the flexibility of the

Federal Reserve, the utilization of the monetary policy tool to lower interest rates and to stimulate economic activity.

Now, that is the regrettable but somber reality of our current economic situation. We do have the option of supporting anti-recessionary measures of an emergency nature. The budget agreement will permit that. But we cannot unravel the core of the 5-year, $500 billion deficit reduction plan, in my judgment.

As this budget year progresses, I intend to defend the budget agreement, to work very closely with the leadership to fashion only the most targeted of anti-recession initiatives in order to blunt the worst economic effects of the coming recession.

Now, before turning to the distinguished ranking member, Senator Domenici, for his observations and comments this morning, let me just say a word about the committee's schedule for today and tomorrow for Senators and their staff. As we all know, the CBO recession certification will trigger expedited procedures in the Senate. It is my understanding that Dr. Reischauer's letter of certification has already been delivered to the majority leader, and under the strictures of the Gramm-Rudman-Hollings law, that letter requires the majority leader to introduce a joint resolution suspending the budget enforcement features of Gramm-Rudman-Hollings, and the Budget Committee will be required to report out that joint resolution within 5 days.

The Budget Committee will conduct a markup on that joint resolution tomorrow morning at 10 a.m. I am hoping that we can conduct much of the discussion of the matter today so that we might come to a vote in relatively short order tomorrow morning. In furtherance of that end, I am hoping that, shortly after beginning the markup tomorrow morning, we will set a time certain to vote on the joint resolution tomorrow morning.

Now let me turn to our distinguished ranking member, Senator Domenici, for his remarks and comments. Senator Domenici?

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Thank you very much, Mr. Chairman, for the hearing. It couldn't be more timely in light of the fact that we will very soon have to decide whether as a committee we want to recommend, in essence, the total abolition of the enforcement part of the budget agreement because of two successive quarters of recession.

I know that I have lamented many times over these many years that I have been on this committee how we face difficult decisions and challenges that are very large. But this hearing on the budget is different. I don't think at any time during these many years have I ever felt this degree of uncertainty regarding some matters, yet absolutely certain regarding some others. I don't think I am alone in these feelings.

I am certain that our leadership in the gulf reaffirms, not to everyone but to a compelling majority, that we are a very special Nation with very special responsibilities. Some may wish it were not so. I am also certain that the real outcome of the gulf campaign will go on long after the last shot is fired by the allies. I think we have entered a new period in American history and in

world history, and the gulf might very well define that role and that situation for the world, which seems to me to be desperate for freedom, for ridding itself of despots, and for opportunity for far more people in the decade of the 1990's.

But there are also some things that I am not so sure about. I am not so sure about the cost of Desert Storm, and I am certain everyone on this committee knows that the costs are uncertain at this time. I pray and hope that these costs measured in terms of lives will be minimal. I believe those who met in the summit conference and then both Houses in ratifying the agreement, did right in concluding that we ought to treat what was then Desert Shield, now Desert Storm, separately from the ongoing budget, and determine from time to time its cost and handle its payment by supplemental appropriations so that we would know exactly what it costs and what our allies were paying.

Uncertainties exist also as to the prospect for the economy, and I think that probably brings us to this meeting as much as anything else. Now, Mr. Chairman and fellow members, we have had many arguments here about economic forecasts. History has shown us that they are less reliable at times of change, whether that change be for the better or for the worse.

How long and how deep will this current downturn or recession be? Again, I happen to be optimistic. If recent economic events hold—and obviously that is a big "if"—I am hopeful that we can put this downturn behind us in short order. The drop in oil prices and interest rates in recent days is encouraging. But I think we all know these are very volatile times. We only have to look at oil prices for the last week to know that.

It would have been better to face this ordeal in the gulf when the economy was stronger, but I believe that in matters of war and peace, as in our personal lives, things happen at bad times and we have to live with them at that time. We didn't choose the timing for this. Apparently someone else did.

These uncertainties continue to exist, and either by some stroke of genius or pure luck, I believe the often-lamented budget agreement we did last fall—which, indeed, may have some components many members of this committee do not agree with from the standpoint of enforcement and setting a fiscal path—is probably the best piece of legislation we could have constructed for these particular times.

Mr. Chairman, you said you will resist dramatically altering it by resolution which will be before us tomorrow. Unless I find out something very different than I know today, let me say I will support you. I believe we ought to leave this agreement alone and leave the caps alone: the caps on nondefense discretionary expenditures and the caps on military expenditures—the expenditures in the Middle East being separate and distinct. And we ought to leave the pay-as-you-go provisions for new programs and entitlements alone now and not abolish them.

During this downturn and recession, the agreement provides for automatic changes in the targets for stabilizers such as unemployment insurance and other programs.

I might recount for some who have been here as long as I, or longer, in the past every time we had a recession or a downturn

there were literally scores of programs offered, billions of dollars suggested to be spent to get us out of the recession, whether it be a jobs program or a public works program or something else. I think history reveals that more times than not we passed many of those, only to find that the recession was over before they were spent.

I don't see a huge array of suggested new programs or new expenditures. I do hear some people speaking of tax adjustments, and I think it would be interesting to listen to those people and hear about those changes in terms of stimulating the American economy in some realistic way, provided all are within the purview of the agreement which certainly permits those kinds of changes through super-majority votes and the like. But we ought not wipe out this structure we so arduously crafted last fall.

Also, it seems to me that when we entered into this agreement, while we didn't recognize the full thrust of what we then called Desert Shield, I think we handled it quite properly, and we ought to stay that course. And this agreement will accommodate the uncertainties attributable to the downturn that we could not accommodate under the previous law. I believe that the three most important things that we put in place we should keep: the mandatory caps on domestic expenditures, the mandatory caps on military expenditures, except those which are occurring because of the conflict, and, indeed, the pay-as-you-go for any new direct spending program or entitlement.

I hope, if we stick to that, we can have a quick budget cycle, get on with the business that Congress must undertake, and have our work done in record time, yet done well.

Thank you very much, Mr. Chairman.

Chairman SASSER. Thank you, Senator Domenici.

I have a statement by Senator Symms which we will make a part of the record.

[The prepared statement of Senator Symms follows:]

PREPARED STATEMENT OF SENATOR STEVE SYMMS

Good morning, Mr. Chairman, it's a pleasure to be a member of this Committee as we begin the 102nd Congress. I think we'll face some interesting questions this year. And while I'll miss the counsel of Bill Armstrong and Rudy Boschwitz, I must say I am glad to be able to work more closely with my good friend Pete Domenici.

I often find myself agreeing with Senator Domenici with one exception. I opposed last year's budget deal. I don't think a tax increase was the answer, and particularly not in the teeth of a recession. And I have seen nothing since to make me change my mind. But that's water under the bridge, and I think we need to move on.

One part of last year's bill I did support was its budget process reforms. Only time will tell if they'll help put a lid on spending. But no one can doubt that some of these changes could not have been timed better.

For example, we now adjust the deficit targets for changes in economic assumptions. So we don't need to pass new targets because of the recession. And most important, now there is no reason to throw out the spending controls. People like Pete Domenici and Chairman Sasser had the foresight to recognize that Desert Shield might become Desert Storm. Last year's bill excluded the costs of Desert Storm from the defense spending caps.

It was and is the right policy because the long term budget effects of Desert Storm are almost certainly going to be minor. The real costs of Desert Storm are going to be a one-time deal, which is why we shouldn't throw out the budget reforms on account of Desert Storm. On the contrary, we should give them a chance to work.

Finally, I think it's entirely appropriate for the Senate Budget Committee to look at the costs of Desert Storm. But, as far as I can tell, Desert Storm will not particularly affect the committee's decisions about this year's budget.

In any case, just to keep things in perspective, what really matters right now is the courage and sacrifice of our men and women in the Gulf, and that our prayers be with them.

Thank you Mr. Chairman.

Chairman SASSER. I have a statement by Senator Kasten which we will make a part of the record.

[The prepared statement of Senator Kasten follows:]

PREPARED STATEMENT OF SENATOR ROBERT W. KASTEN, JR.

THE STATE OF THE ECONOMY, CBO ESTIMATES

Thank you, Mr. Chairman. One thing that I hope will be made clear at today's hearing is something that should be self-evident to everyone: The best way to fight the deficit is to keep the economy growing.

Even if the Congress adheres to the spending limits and tax increases of last year's budget summit, a pro-longed recession could add $60 billion to the 1992 budget deficit.

So enacting anti-recession, incentive-based economic policies is the best thing we can do to keep a lid on the deficit. We must reduce the tax on working families and small businesses through payroll tax cuts—which incidentally will have no effect on our efforts to meet the Gramm-Rudman targets because social security is off-budget.

Our colleague Senator Pat Moynihan cites economic studies showing that this tax cut bill—which I have cosponsored—will create 1 million new jobs.

Second, we ought to enact a revenue-winning cut in the capital gains tax. Given the troubles in our financial sector, I think we are starting to find a real capital shortage—particularly for smaller firms. Most economists agree that a capital gains tax cut would tend to increase the availability of venture capital

I think these two measures will go a long way towards re-invigorating our economy, reducing the deficit and, more importantly, reducing the real human costs of layoffs and plant closings that result from recession.

Chairman SASSER. We will proceed now to the testimony of Dr. Reischauer, the Director of the Congressional Budget Office. We welcome you here this morning, Dr. Reischauer, although I am advised that you are bringing rather gloomy news. But you may proceed.

STATEMENT OF ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. REISCHAUER. Thank you, Mr. Chairman and members of the committee. I appreciate the opportunity to discuss CBO's current economic outlook with you. With your permission, I will submit my prepared statement for the record of these hearings and confine my remarks to a summary of CBO's forecast and some related matters.[1]

Let me get immediately to the bottom line, which is that CBO believes that the U.S. economy is now in the midst of the ninth recession of the postwar period. We expect that real GNP declined in the fourth quarter of 1990, and we also expect that it will decline further in the first quarter of 1991. In accordance with Section 254(j) of the Balanced Budget and Emergency Deficit Control Act, I have notified the congressional leadership of this forecast. I have also notified the leadership that Director Darman of OMB has in-

[1] See p. 15.

formed me that the administration will release a forecast that also contains two consecutive quarters of negative economic growth.

With your permission, I will submit a copy of both my letter and Director Darman's letter to me for the record of these hearings.

Chairman SASSER. They will be included, without objection, in the record.

[The letters referred to by Mr. Reischauer follows:]

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

Robert D. Reischauer
Director

January 17, 1991

The Honorable Dan Quayle
President of the Senate
United States Senate
Washington, DC 20510

Dear Mr. President:

Under section 254(j) of the Balanced Budget and Emergency Deficit Control Act of 1985 (2 U.S.C. 904(j)), the Congressional Budget Office must notify the Congress in the event of an economic downturn. The section reads in part:

> (j) LOW-GROWTH REPORT.-At any time, CBO shall notify the Congress if-
>
> (1) during the period consisting of the quarter during which such notification is given, the quarter preceding such notification, and the 4 quarters following such notification, CBO or OMB has determined that real economic growth is projected or estimated to be less than zero with respect to each of any 2 consecutive quarters within such period....

This letter serves to notify the Congress that the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) project real economic growth to be less than zero with respect to the last quarter of calendar year 1990 and the first quarter of calendar year 1991. A letter from the Director of OMB informing CBO of the OMB forecast is enclosed.

Sincerely,

Robert D. Reischauer

Enclosure

cc: Honorable George J. Mitchell
Senate Majority Leader

Honorable Robert Dole
Republican Leader

Honorable Jim Sasser
Chairman, Senate Committee on the Budget

Honorable Pete V. Domenici
Ranking Minority Member

Honorable Richard G. Darman
Director, Office of Management and Budget

IDENTICAL LETTER SENT TO: Honorable Thomas S. Foley, Speaker of the House

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

Robert D. Reischauer
Director

January 17, 1991

The Honorable Thomas S. Foley
Speaker of the House
U.S. House of Representatives
Washington, DC 20515

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Sincerely,

Robert D. Reischauer

Enclosure

cc: Honorable Richard A. Gephardt
Majority Leader

Honorable Robert H. Michel
Republican Leader

Honorable Leon E. Panetta
Chairman, House Committee on the Budget

Honorable Willis D. Gradison, Jr.
House Committee on the Budget

IDENTICAL LETTER SENT TO: Honorable Dan Quayle, President of the Senate

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

THE DIRECTOR

January 15, 1991

Robert D. Reischauer
Director
Congressional Budget Office
Washington, D.C. 20515

Dear Bob:

The Balanced Budget and Emergency Deficit Control Act (Section 254(j)) requires the Congressional Budget Office (CBO) to notify Congress if "CBO or OMB has determined" that real economic growth is estimated to be less than zero for two consecutive quarters within a specified period.

Our staffs have, as is our custom, exchanged economic forecasts, including forecasts of real economic growth. In our case, we have provided you with the latest draft of the "Troika's" forecast -- for it is that which we are using in developing our FY '92 budget estimates. It is clear from our staff exchange that both CBO and the Administration are about to forecast real growth of less than zero for the fourth quarter of 1990 and the first quarter of 1991. (The Troika estimate assumes a decline in real economic growth of 3.4 percent for the fourth quarter of 1990 and 1.3 percent for the first quarter of 1991.)

When either the CBO or the OMB forecasts are officially made public, the issue of CBO notification to Congress under Section 254(j) will arise. It is my understanding that you now plan to release your forecast on or about January 17th. Rather than create the possibility of separate CBO notifications for the CBO and OMB determinations, we recommend that when CBO notifies Congress of its forecast, it simultaneously notify Congress of the OMB determination.

To that end, when you decide to release the CBO forecast, please allow this letter to serve to advise you officially that "OMB has determined that real economic growth is projected or estimated to be less than zero with respect to each of any two consecutive quarters within" the period designated in section 254(j). We propose that CBO include this letter in its notification to Congress pursuant to Section 254(j).

With best regards,

Richard G. Darman
Director

Mr. REISCHAUER. My discouraging assessment of the current economic situation should be tempered by CBO's expectation that this recession will be shorter and milder than the average postwar downturn. The recession should end by midyear and should be followed by a period of solid economic growth and significantly lower inflation.

CBO's economic forecast calls for real GNP to grow about 1.3 percent between the fourth quarter of 1990 and the fourth quarter of 1991. For 1992, we expect fourth-quarter-over-fourth-quarter growth to be in the neighborhood of 3.5 percent. The unemployment rate should increase from an average of 5.5 percent, which we experienced in calendar year 1990, to about a 6.8 percent average for calendar year 1991. It should then decline a bit in response to the recovery to about 6.4 percent for 1992.

The pain of the recession should bring the traditional benefit of reduced inflation. During most of the 1980s, the underlying rate of inflation hovered between 4 and 5 percent. After this recession, it should fall to somewhere between 3 percent and 4 percent.

The recession will cause a further reduction in interest rates. Long-term rates should fall in response to the expectations of lower inflation, and short-term rates should ease slightly as the Federal Reserve continues to relax monetary policy to help moderate the recession.

We are a society that loves to point fingers and assign blame, and, therefore, many have asked the question: Why did the economy fall into this recession? It is, of course, impossible to disentangle the individual contributions of the various factors that have played a role in bringing about this downturn. However, I can list the major ingredients for you.

Prime among them is the relatively tight monetary policy that the Federal Reserve has followed over the past few years. While this policy was successful in preventing a reemergence of inflationary pressures, it slowed growth to the point that the economy was vulnerable to external shocks.

Iraq's invasion of Kuwait represented just such a shock. It raised oil prices, consumer prices, and interest rates, which in turn reduced consumer and business confidence and spending.

A third ingredient that helped to precipitate this recession was the tightening of credit available to the private sector. Banks and bank regulators have tightened lending standards in the past year in response to weak real estate prices and the other problems that have been facing the thrifts and commercial banks.

CBO's forecast is somewhat more optimistic than many of the forecasts that are available, and, therefore, it might be useful if I elaborated on the reasons why we believe that the current recession is likely to be relatively short and relatively shallow. CBO's view rests on several of the differences that are evident between this economic slowdown and the previous postwar economic downturns that we have experienced.

The first of these differences relates to inventories. The slowdown in sales that occurred early in the recession did not lead to the usual sharp accumulation of inventories, and, therefore, the current ratio of inventory stocks to sales is relatively low. Without

an inventory overhang, increases in sales should translate quickly into increased orders and increased production.

A second reason for optimism is that real exports are expected to remain strong over the next 2 years as a result of the dollar's recent decline and the relatively healthy growth that is expected in the non-English-speaking part of the world. This strength will help to offset the weakness that we see in other sectors of the economy.

A third reason not to be swept up in the tide of pessimism comes from the realization that the current oil shock is relatively mild and could be relatively short, when compared with those of the 1970s. Adjusted for inflation, the 1990 increase in oil prices amounts to roughly 65 percent of the 1973 increase and to only about half of the 1979 increase in oil prices. Future significant price increases are unlikely because the loss of Kuwait and Iraq supplies has been fully offset by increased production elsewhere, primarily in Saudi Arabia, and because oil inventories are now relatively abundant.

Moreover, the United States is better able to withstand any disruption because we are a more energy-efficient economy now than we were in the 1970s. In fact, the energy efficiency of our economy has improved about 26 percent over the last 15 years.

A final factor that argues for optimism is the policy latitude available to monetary authorities. Unlike the situations at the start of the past three recessions, high or accelerating inflation should not be a major concern. There is little evidence that the underlying rate of inflation has moved outside the 4 percent to 5 percent range that has persisted since 1983. Moreover, rising unemployment and declining factory operating rates should help dampen future price increases.

With the passage of the budget process reforms contained in OBRA, fiscal policies should exert an increasingly restrictive force over the next 5 years. What all this adds up to is that the Federal Reserve should have less concern about the inflationary consequences of relaxing monetary policy than was the case during the early months of any of the last three recessions.

Let me conclude by noting that the CBO forecast has been made at a time when there is extraordinary uncertainty about the economy. Developments in the Gulf which impinge on the economic outlook in obvious ways are one major source of uncertainty. In addition, there is a good deal of uncertainty about whether banks and other financial institutions are in a position to extend sufficient credit to the nonfinancial sectors of the economy. Because of this uncertainty, my prepared statement lays out two alternative forecasts. The more pessimistic one posits an average postwar recession with respect to the depth and duration of the downturn. The more optimistic one has a slightly stronger rate of growth than the CBO base forecast.

My current sense is that the first of these two scenarios may be a bit more probable than the second. The relatively mild and short recession detailed in the CBO base forecast reflects our best judgment with respect to the future course of the economy.

That ends my statement, and I will be glad to answer any questions.

Chairman SASSER. Thank you very much, Mr. Reischauer.

[The prepared statement of Mr. Reischauer follows:]

CBO TESTIMONY

Statement of
Robert D. Reischauer
Director
Congressional Budget Office

before the
Committee on the Budget
United States Senate

January 23, 1991

NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EST), Wednesday, January 23, 1991.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Mr. Chairman, I appreciate this opportunity to discuss the current economic outlook. This is my first appearance before a Committee of the 102d Congress, and I wish only that the message I am about to present were more positive.

THE SHORT-TERM ECONOMIC FORECAST

CBO, like most other forecasters, believes that the U.S. economy is now in its ninth recession of the postwar period. This recession should be shorter and milder than the average postwar downturn. CBO expects the recession to end by midyear and to be followed by a period of solid economic growth and significantly reduced inflation. However, because this forecast is quite uncertain, especially given the situation in the Persian Gulf, I will also describe some alternative forecasts that illustrate other possible outcomes.

CBO's economic forecast calls for real GNP (gross national product) to grow about 1 1/2 percent between the fourth quarters of 1990 and 1991 (see Table 1). This forecast incorporates a decline in economic activity for the fourth quarter of 1990 and the first quarter of 1991. The recession will expand the gap between actual production and the economy's capacity to produce. Thus, there will be room for higher growth on average in the years after the recession as the economy catches up to its potential. For 1992, the growth rate is expected to rise to about 3 1/2 percent. This pattern of growth

in output is reflected in employment as well. The recession sharply increases the unemployment rate-from 5.5 percent in 1990 to 6.8 percent in 1991, while the recovery causes it to drop below 6 1/2 percent in 1992.

After the recession, the inflation rate is apt to be significantly lower than it has been during most of the 1980s--down from between 4 percent and 5 percent to between 3 percent and 4 percent on a sustained basis. In other words, the pain of the recession will bring about the traditional benefit of reduced inflation.

The recession will cause a further reduction in interest rates. Long-term rates should fall in response to expectations of lower inflation, and short-term rates should ease slightly as the Federal Reserve continues to relax monetary policy to help moderate the recession. The rate on 10-year Treasury notes, which averaged 8.6 percent in 1990, is expected to fall to 7.9 percent in 1991. The three-month Treasury bill rate, which was 7.5 percent in 1990, is expected to average 6.6 percent in 1991. As the economy recovers, short-term interest rates are expected to rebound slightly in the second half of this year and early 1992 . In contrast, long-term interest rates, responding to the permanent lowering of inflationary expectations, will remain low.

Why the Economy Entered a Recession

Steering the economy between excessive inflation and inadequate growth is difficult. To its credit, the Federal Reserve navigated the economy relatively successfully between these two dangers during the late 1980s. In an attempt to prevent inflationary pressures from reemerging, it maintained a relatively tight monetary policy. But as the rate of economic growth slowed, and the July 1990 revisions to the national income and product accounts revealed that the economy was weaker in 1989 than originally recognized, the risk of a recession grew larger.

In the second half of 1990, the effects of Iraq's invasion of Kuwait rocked the economy. The invasion raised oil prices, consumer prices, and interest rates, which in turn reduced consumer confidence and spending. In addition, the decline in property values in some areas of the country together with the lingering effects of the savings and loan crisis pressured banks and bank regulators to tighten lending standards. This tightening led to reductions in the availability of credit to the private sector. CBO believes that the Iraqi invasion, coupled with a tightening of credit because of the problems in the banking and thrift industries, played an important role in precipitating the recession.

Why the Recession is Expected to be Mild

While the decline in economic activity is unmistakable, the current slowdown differs from previous postwar downturns, and these differences suggest that a short and shallow recession is likely. Several factors contribute to this view. They include changes in the structure of the economy, the likely strength of net exports, the nature of the current oil price shock, and the flexibility currently available to the monetary authorities.

Structural Changes. In the past, inventory stocks have increased sharply and unexpectedly following the onset of a recession, leading businesses to cutback orders of new goods. Manufacturing production and employment have fallen sharply in response, which has tended to exacerbate the initial effects of the downturn. Such effects, however, are unlikely to complicate the current downturn. The current ratio of inventory stocks to sales is comparatively low. Although sales slowed early in this recession, such slowing did not lead to a sharp accumulation of inventories, perhaps because the slowdown had been expected as a result of the tight monetary policies of earlier years and because of improved management of inventories.

In addition, the service-producing sector has provided an increasing share of total income and employment over the postwar period. Because the

service sector is less sensitive to the business cycle than is the goods-producing sector, a given decline in the goods sector will not have as prominent an effect on total income as was the case in previous downturns.

Net Exports. Real exports are currently strong and are expected to remain so over the two-year forecast period. Such strength will help to offset weakness in other sectors. The sources of this strength are the dollar's decline over the last year as well as the relatively healthy growth in foreign demand.

Since mid-1989, the dollar has depreciated about 17 percent in inflation-adjusted terms against the currencies of our major trading partners. Much of the stimulative effect of this depreciation remains to be felt. Because of the continued decline in U.S. interest rates relative to those abroad, CBO does not expect this depreciation to be reversed.

Although economic growth has slowed recently, it continues in much of the rest of the world, helping to sustain the growth in U.S. exports. The greatest economic strength is in western Germany, which is enjoying a boom as a result of unification. Economic strength is also pronounced in Japan, where growth continues despite marked reversals in financial markets.

Growth in these countries should offset the effects of the recessions that have apparently begun in Canada, the United Kingdom, and Australia.

These same developments are likely to continue to hold interest rates at high levels in 1991. For example, German unification has pushed world interest rates upward in the past year, both because of the demand for funds to finance new investment in what was East Germany and because of the large budget deficits that the German government has incurred in order to finance unemployment compensation and other benefits for east Germans. Upward pressures on interest rates also stem in part from Japan, where financial markets have declined and monetary policy has been tightened to prevent an upsurge in inflation in response to the continued high rate of economic growth.

Nature of the Current Oil Shock. The current crisis in the Persian Gulf is not likely to generate the economic repercussions that followed the earlier disruptions in oil supplies in 1973 and 1979. The Iraq-Kuwait supply disruption so far is much smaller than the earlier supply shocks, and the United States and other oil-importing countries are better prepared today for disruptions in oil supplies than was true earlier.

Adjusted for inflation, the increase in oil prices that was brought about by the Iraqi invasion of Kuwait amounts to roughly 65 percent of the increase that followed the embargo by the OPEC in 1973, and to about 50 percent of the increase that followed the price increase that OPEC imposed in 1979.

The current disruption in oil supply is smaller than in the past both because the initial loss of oil was smaller and because some of the initial price shock was mitigated by both demand- and supply-side factors. Oil-exporting nations have replaced all of the oil lost from Iraq and Kuwait and are adding to their surplus capacity. In addition, world and domestic inventories of oil are now relatively abundant because stocks of oil at the onset of the crisis were very high and because demand for world oil fell off sharply in the last quarter of 1990.

The United States, like other oil-importing countries, is also better prepared for high oil prices in the 1990s because it has come to use energy more efficiently. By 1988, the use of energy per dollar of gross domestic product (GDP) had fallen to 74 percent of its 1973 level.

Monetary Policy and the Outlook for Inflation. The Federal Reserve responded to the initial signs of weakness in the economy by a slight easing of its tight monetary policy in mid-1990 and a more dramatic easing late in

the year. The current state of the economy should permit further easing without a pickup of inflation. Most of the 1990 increase in overall consumer inflation was related to energy and has already dissipated. In fact, there is little evidence that the underlying rate of inflation has moved outside the 4 percent to 5 percent range that has persisted since 1983. Moreover, the rising unemployment rate will help to restrain future wage increases, while declining factory operating rates will help hold down other prices as well.

The State of Fiscal Policy

Passage of the Omnibus Budget Reconciliation Act (OBRA) of 1990 represents a major step forward in this nation's budgetary policy. CBO projects that the act will reduce federal borrowing over the next five years by nearly $500 billion, and sharply reduce the annual deficit both in dollars and in relation to GNP. To be sure, the deficit is going to balloon to record levels this year and next because of the recession and spending for deposit insurance. The favorable longer-term trends, however, are clear.

Although OBRA reduces spending and raises taxes, overall fiscal policy in 1991 is unlikely to be significantly contractionary. The costs associated with the military operation in the Gulf could offset a substantial amount of the

OBRA deficit reductions in 1991. While the estimates are highly uncertain, the incremental costs associated with the deployment of forces in the Gulf region and the hostilities there could be well in excess of $15 billion. While not all of these costs will result in outlays in 1991, a substantial share of the portion that is spent could stimulate the U.S. economy, since it is likely to be spent on goods and services produced in the United States. Such outlays should offset some of the reductions mandated by OBRA for the current fiscal year.

In any case, as with earlier recessions, the current recession will cause the budget deficit to increase in 1991, which will help to ease the severity of the economic downturn. Taxes will automatically be less than, and transfer payments automatically greater than, what they would have been without an economic slowdown. As a result of these "automatic stabilizers," the reductions in consumption and other components of GNP will be dampened.

Risks to the Forecast

CBO's forecast has been made at a time when there is extraordinary uncertainty about the economy. Military developments in the Gulf, which impinge on the economic outlook, are a major source of uncertainty. In

addition, there is a good deal of uncertainty about whether banks and other financial institutions are in a position to extend sufficient credit to the rest of the U.S. economy.

With respect to the Middle East, the CBO forecast assumes that the unpredictable situation in this region keeps oil prices at about $25 a barrel, and that U.S. military spending is relatively modest. The forecast also assumes that the credit crunch will remain relatively mild.

These assumptions, however, could easily turn out to be wrong. On the one hand, a speedy resolution of the Gulf conflict could lead to lower oil prices that could improve the short-term economic outlook. On the other hand, adverse events could significantly increase oil prices, putting a damper on economic activity in the United States and elsewhere.

With respect to the financial problems of banks, a further deterioration in credit conditions is possible if real estate prices continue to decline, and if banks with loan portfolios sensitive to the real estate market weaken further. In any case, regulatory and self-imposed pressures on banks to increase the overall quality of their assets and reduce bank size could work to slow the recovery by restricting the supply of credit.

Alternative Forecasts

To account for these risks, CBO developed two alternative forecasts, one entailing a more severe recession, and the other a slightly shallower one. These alternatives give a flavor of other possible outcomes, but by no means do they encompass the range of possible economic scenarios.

The *high-growth alternative* makes relatively optimistic assumptions about oil prices, inflation, and the credit crunch. Oil prices are assumed to fall quite quickly to around $15 a barrel, followed by an increase to around $20 by the end of 1991. This oil price scenario obviously entails some sort of quick resolution of the Gulf conflict that allows at least some additional oil onto the markets, either from extra production or from existing stocks. The excess of new supplies would push prices at least temporarily below $20. In addition, this alternative assumes that the economic weakness we are experiencing reduces inflation by more than the CBO forecast assumes. The high-growth alternative forecast also assumes that the credit crunch turns out to be minor.

The more favorable outlook for inflation in this forecast allows interest rates to be lower than in the CBO forecast, despite stronger growth. These lower interest rates come about both because expectations of inflation are

lower--a major factor in long rates--and because the more optimistic outlook for inflation means that the Federal Reserve has less to do to bring inflation within acceptable bounds.

In contrast, the *low-growth alternative* assumes that oil prices are temporarily higher than in the CBO forecast, and that the outlook for real GNP is substantially worse. Instead of a mild recession, this alternative calls for a recession of about average depth and duration. It is not simply a mirror image of the high-growth alternative, and does not make opposite assumptions in every respect. Nevertheless, the assumptions are generally more pessimistic.

Oil prices in this alternative are assumed to rise to the $35 to $40 range for about six months, before falling by the end of 1992 to levels close to those in the optimistic alternative. Such a scenario implies a resolution of the Gulf conflict, but a much more painful one than that assumed in the high-growth alternative.

The main reason for weak growth in this alternative forecast is, however, not the higher path of oil prices: it is that the credit crunch is assumed to become substantially worse than it currently seems. This turn of events would weaken private domestic spending. Indeed, although military

spending in this alternative could be substantially higher than in the baseline, it is assumed nevertheless that the private spending would be even weaker.

Inflation in the low-growth alternative forecast is slightly higher in 1991 than in the CBO forecast because of the temporarily higher oil prices. But by 1992, falling oil prices together with lower growth in non-oil prices because of the recession, sharply reduce the growth of the consumer price index (CPI).

Finally, in the low-growth scenario, short-term rates are lower than in the base forecast, because they reflect the effects of lower credit demands in a recession as well as efforts by the Federal Reserve to offset the assumed credit crunch.

Comparison with Other Forecasts

The CBO forecast for real GNP is considerably lower than what CBO predicted last June (see Table 2). That forecast was prepared before the Iraqi invasion, before the major downward revisions to estimates of economic growth in 1989 and early 1990, and before evidence of the seriousness of the credit crunch had emerged. The new forecast differs from the old primarily because of these changes.

Other forecasters have also revised their views since last summer. The *Blue Chip Economic Indicators*, which provides an average of forecasts made by some 50 economists, has lowered its growth prediction for 1991 since last summer. The current *Blue Chip* average forecast for real GNP growth in calendar year 1991 is slightly lower than CBO's. Moreover, relative to last summer's prediction for 1991, the individual forecasts for growth in the current *Blue Chip* average are more widely dispersed around the average, possibly an indication of the uncertainty present in the current economic climate.

THE MEDIUM-TERM ECONOMIC PROJECTIONS

CBO does not try to forecast short-term fluctuations in the economy more than two years into the future. Instead, for the 1993-1996 period, we project the trends in important underlying variables, such as labor supply, productivity, and saving rates. Variables such as real GNP, inflation, and interest rates are projected on the basis of the gaps between the values of these variables that are forecast for the end of 1992 and the potential or long-run values that are implied for them by CBO's projections of underlying economic trends.

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Real Gross National Product

CBO projects that potential GNP will grow on average by about 2.3 percent a year. This projection, which is slightly lower than CBO's estimates of last summer, reflects the recent benchmark revisions to the economic data, which suggest that productivity has been growing more slowly in recent years than earlier data had indicated. In addition, the projected growth in potential output takes account of the expected slowing in the growth of the labor force, as well as the increases in capital per worker that will stem from reductions in the federal deficit.

Real GNP is projected to grow at an average rate of 2.8 percent over the 1993-1996 period as a result of the relatively large gap between actual and potential GNP that appears during 1991 and 1992 because of the recession (see Table 3). A healthy growth rate will be possible as the economy recovers and resources are more fully used.

Interest Rates

Interest rates in the projection are set by reference to the historical pattern of real interest rates and increases in national wealth that existed during the

1960s. During that decade, real long-term interest rates averaged about 2.3 percent, while about 7.6 percent of real net national product was devoted to increases in wealth--that is, either invested in this country or loaned abroad. In the 1990s, CBO projects that the assumed reduction in the federal deficit will raise the rate of accumulation of national wealth, thereby exerting downward pressure on interest rates. This downward pressure will be offset by the increased capital demands associated with developments in Europe. As a result, CBO projects real short-term interest rates in the mid-1990s of about 2 percent, and real long-term rates of about 3 1/2 percent.

CONCLUSION

The nation clearly faces a difficult period in the next several months. A significant economic slowdown seems assured, though just how long and how severe it will be is highly uncertain. A resolution of the conflict in the Gulf will help determine that outcome, but a complete picture of the nation's economic prospects will elude us until we have a clearer picture of the health of the nation's financial system. The slowdown, one hopes, will prove to be short and will provide the foundation for a period of renewed moderate growth and lower inflation.

Chairman SASSER. You are forecasting two consecutive quarters of negative economic growth—well, not forecasting, I think the last quarter of 1990 is a reality, and you are forecasting negative economic growth for the first quarter of 1991, and the Senate is going to have to shortly deal with the question of whether or not to suspend the strictures of the Gramm-Rudman-Hollings Act, with regard to sequester for the remainder of fiscal year 1991 and 1992.

What is your view of whether or not it would be in our best economic interest to suspend the budget agreement that we entered into last year during this period of recession?

Mr. REISCHAUER. My judgment is that at this time it would be a mistake to suspend the discipline that was agreed to last fall. There are five basic arguments that one can make for that position.

The first of these is that the remedy that is provided by the joint resolution is really excessive, if you believe we are in the midst of a relatively mild and short recession as the CBO forecast suggests. The joint resolution would suspend the enforcement procedures not only for the balance of the current fiscal year, but also for fiscal year 1992, and so you would be relaxing the discipline for a period of approximately 20 months.

The second reason why I think it would be a mistake is that the passage of a joint resolution could turn out to be ineffectual, because any boost that one might hope to get from countercyclical fiscal policy might be offset by responses in financial markets. The passage of the budget summit agreement last fall sent a very positive message to financial markets, one that we believe caused long-term rates to decline. If, after biting the fiscal discipline bullet last fall, the Congress spits it out 3 or 4 months later, I think there will be an adverse reaction, and one could see long-term rates bounce up a little. In addition, it is perfectly possible that the Federal Reserve would be less willing to ease monetary policy if it felt that fiscal policy was in danger of being unrestrained.

A third factor that I think argues for not suspending the discipline at this point is that fiscal policy may not be as tight as we expected last fall, when the Omnibus Budget Reconciliation Act (OBRA) was passed. The simple reason is that we have increased expenditures associated with Operation Desert Shield and Operation Desert Storm, and these increased expenditures are providing some modest amount of fiscal stimulus to offset the contractionary effects of the budget reductions that were accepted.

Fourth, as the chairman pointed out, there is an alternative. If at some point it was decided that the economy needed a small injection of fiscal stimulus, one could turn to the emergency provisions of the new budget process and design an appropriately sized and shaped package of measures that the President and the Congress could designate as an emergency, and would not, therefore, involve suspending the entire discipline of the process for a 20-month period.

Finally, I think the Congress should not fear that it would be making a precipitous or irreversible judgment if it rejects in the next couple of weeks the joint resolution because of the simple fact that this issue is going to come back again. This issue is going to be

as persistent as Dracula—it will be hard to drive the stake through the heart of this issue.

On April 26th, the Commerce Department will release its preliminary estimate of first-quarter growth. It will probably show economic growth in the first quarter to be less than 1 percent. Growth in the last quarter of 1990 was almost certainly below 1 percent. Therefore, we will have two actual quarters of growth below 1 percent, which under the law will require me once again to notify the Congress that we have experienced low growth and once again will put before this committee a joint resolution. This could——

Chairman SASSER. That would come in April?

Mr. REISCHAUER. Excuse me?

Chairman SASSER. That will come in April, Dr. Reischauer?

Mr. REISCHAUER. April 26th. It is not inconceivable that it will reappear again on July 30th, when the second-quarter number comes out. Hence, it is perfectly possible that the first and second quarters of 1991 will constitute two consecutive quarters of less than 1 percent actual growth, and therefore this issue will once again come before you.

Chairman SASSER. Just let me ask you——

Mr. REISCHAUER. If the recession is more severe than CBO and some other private forecasters fear, there will be another chance to address this issue.

Chairman SASSER [continuing]. Just let me ask you to conjecture for one moment. Suppose you come back to us in the spring and you are projecting less than 1 percent real growth for the second quarter of 1991. Now, that is going to give us three consecutive quarters.

Mr. REISCHAUER. We would have to be projecting below zero.

Chairman SASSER. All right. So, you project below zero in the second quarter of 1991. That gives us three consecutive quarters of no real growth. What would be your recommendation to us at that juncture about whether or not to suspend the strictures of Gramm-Rudman-Hollings, and whether or not to enforce the budget agreement? Have you thought that far ahead on that, Dr. Reischauer?

Mr. REISCHAUER. I think it would be premature to say. You would want to look at all of the factors and decide whether we really were on our way out of this recession and what was happening with respect to Gulf-related fiscal stimulus and that sort of thing. For that reason I think it would be premature.

Chairman SASSER. Dr. Reischauer, the Congressional Budget Office issued a memorandum that has been widely quoted in the media. I saw it as late as last night, I think on the CBS Evening News, that the cost of Desert Storm could run anywhere from $28 billion for a short war to $86 billion for a prolonged conflict.

The distinguished chairman of the Senate Armed Services Committee, Senator Nunn, was quoted this morning, I presume accurately—that is always a dangerous presumption—that the war could cost somewhere in the neighborhood of $89 billion.

Could you narrow your estimate for us today from the $28 billion to $86 billion range that you gave us a few weeks ago? Could you narrow that range today and give us what you think might be a more realistic estimate of Desert Shield and Desert Storm for fiscal year 1991?

Senator DOMENICI. Mr. Chairman, might I just ask the chairman to indulge me for a moment? I have to go to a meeting of the Energy Committee which makes the assignment of your committee work, and I will return in probably 15 minutes. I have no objection to your proceeding. I have no Republicans who will be here during that period of time.

Might I just add, in your question you are asking for costs, and I wonder if you might just ask the witness to clarify whether any of these estimates include what others might pay, or are they to be total incremental costs? I think that is relevant and I would appreciate it if you would ask that in my absence.

Chairman SASSER. Thank you.

If you can, you might give us two estimates, one of what the total cost would be, and then one of what U.S. costs would be.

Mr. REISCHAUER. Let me explain the numbers that the press reports have attributed to CBO. These were estimates that we made at the request of the chairman of this committee for several scenarios. One scenario was the cost of maintaining a presence in a nonconflict posture in the Gulf area of about 400,000 to 450,000 troops for a full year. Second was a negotiated settlement that involved a drawdown of U.S. troop strength to 100,000 by the end of this fiscal year. And the third scenario was a conflict ranging from a relatively short war of several weeks to a longer conflict that might stretch out over a 6-month period.

We obviously did this before hostilities broke out, and so the only relevant portion of that memo at this point is the conflict estimate.

Our estimates of the cost of the deployment and maintenance of the troops during the October through mid-January period, plus the cost of the subsequent hostilities for the current fiscal year, ranged between $17 billion for a short conflict and $35 billion for a longer conflict.

To this we added out-year costs, the costs that might be realized in fiscal year 1992 and beyond, and that is the source of these totals of $28 billion to $86 billion.

The CBO estimate of $17 billion for a relatively short war would probably be close to the costs that seem the most probable at this point. A lot of details of our estimate do not match exactly what is happening, but it is clearly too early to tell at this point.

The larger numbers, the $28 billion to $86 billion numbers, assume that all of the munitions that are expended, the ordnance and the equipment, will be replaced. That is a very open question, and we have to be very careful when we are talking about the cost of this conflict to distinguish between resource costs and budget costs.

The conflict so far is chewing up a lot of resources. We are dropping a lot of bombs, we are sending Cruise missiles off at a fast rate, and these are expensive items—well over $1 million apiece, but their use is not reflected in the budget in any way. They are coming out of our stockpiles and our inventory, and it is an open question whether those resource costs will be turned into budget costs. These stockpiles and inventories were designed to deter aggression by the Soviet Union and the Warsaw Pact countries. We had very large stockpiles and inventories for that purpose.

In the post-cold war world, we may make a decision that stockpiles of that sizes will no longer be needed, and so we may not replace all or perhaps even any of the expended resources.

Certain kinds of ongoing expenditures, such as increased fuel costs, increased maintenance for the tanks, the cost of clothing, food, transportation, and things like that, clearly have to be paid for, and thus will be reflected in the budget. Whether those will increase the deficit, though, is a question that is difficult to answer at this point. The simple reason is that some of those costs are being offset by contributions from our allies. Through December 30th, we had received, I believe, $4.6 billion in cash assistance and $1.3 billion in in-kind assistance from our allies.

Chairman SASSER. Is that cash on hand or checks in the mail?

Mr. REISCHAUER. That was cash on hand, and I understand some checks are in the mail and there are promises on the telephone wires, too. but obviously you do not want to count them until they are in your pocket.

Chairman SASSER. Thank you, Dr. Reischauer. I have got here——

Mr. REISCHAUER. I might just add one thing, which has not received a lot of attention but might really be quite important, even though our report did not analyze it in any kind of detail. That is the possibility that we may have some rather significant post-hostility costs, and these might come in several forms.

After virtually every military engagement in the past, we have extended aid to our allies and even to defeated parties, and we may have such costs this time. In today's newspaper, there was mention of the state of Israel's interest in increased United States aid.

Second, our experience in the Middle East conflict may lead us to rethink our current defense plans, which call for a reduction in U.S. force levels of about 25 percent over the next 5 years—that is going from active-duty armed forces of 2.1 million down to about 1.6 million. Military planners, the Congress, and the President might rethink that level and ask whether we could mount an effort of this scale if we had active-duty armed forces of 1.6 million. That might change the budget outlook in the future.

In addition, conceivably we would want to preposition equipment or forces in parts of the world such as the Gulf that are unstable, which could lead to added military expenses over and above those we are considering here today.

Chairman SASSER. Thank you, Dr. Reischauer.

In order of arrival this morning, Senator Exon is next. Senator Exon.

Senator EXON. Mr. Chairman, thank you very much.

Dr. Reischauer, I listened with a great deal of interest and am very pleased to know that you are predicting a relatively short and shallow recession. I mean that makes the picture a little bit brighter on this side of the table.

Without getting into all of the specifics about that and about your projections of the deficit in the future, back during the time when Gramm-Rudman-Hollings was first instituted, did your agency at that time project that we would indeed balance the Federal budget by fiscal 1990 or 1991?

Mr. REISCHAUER. I was not in my current position at that time, but I am sure we did not project that the budget would be balanced, because our basic method of projecting budget numbers is the baseline budget. This simply takes the appropriation levels of the previous year, the latest enacted appropriation levels, and adjusts them for inflation over a 5-year period, keeping tax policy and entitlement laws unchanged. What was required to meet the Gramm-Rudman-Hollings targets, of course, was a series of discretionary tax increases and spending cuts on which the Congress and the President were supposed to agree and which would not have been in our projections.

Senator EXON. What about your current projections and for a year from now or some future date, do you——

Mr. REISCHAUER. We are in the midst right now of doing our budget projections. We do our economic projection forecast first, and then we sit down and crank that into our budget numbers.

Senator EXON. When will that be available?

Mr. REISCHAUER. That will be available at the end of the month, but I can tell you we are predicting a deficit for the current fiscal year in the neighborhood of $300 billion and probably a very high deficit for 1992 as well. Then the deficit picture improves substantially so that by 1995, as the chairman mentioned, the deficit should be down below $100 billion. In that event the deficit will be below 1 percent of GNP for the first time in some 20-odd years, as a result of the deficit reduction measures that were approved by the Congress last October. So the picture is very bleak in the short run. We are going to have at least 2 years of record deficits in this country, but after that, it should improve.

The major causes for the hemorrhaging of the deficit this year and next are, first, to the weakness in the economy, and second the deposit insurance accounts. The deposit insurance situation and the economic outlook should both improve markedly as we move into the middle of the decade of the nineties.

Senator EXON. Thank you, very much, Doctor. As I understand, in December of 1990, you had predicted a $253 billion deficit in 1991, and now you are telling us that's up about $100 billion, is that correct?

Mr. REISCHAUER. No; probably about $50 billion—$40 to $50 billion. When we released that interim assessment of the budget agreement, we noted that the economic forecast which it was based was done in late September and early October, and therefore was a little out of date, a little too optimistic, and that the projections did not take into account our technical reestimates.

Senator EXON. OK, thank you, doctor, I am about out of time, but let me ask the question that I want to get to.

You had indicated that this was a short and shallow recession. Then I heard you say something about an average based upon postwar recessions.

I take it then that the estimates that you are giving us this morning are based upon what the experience has been in the past, since the post-war recessions. In other words, you are just projecting into the future based upon what has happened in the past?

Mr. REISCHAUER. Taking the average of the eight recessions in the postwar period before the current recession, there has been a

decline in real GNP of 2.6 percentage points from the peak to the trough, and the average duration of the recessions has been 11 months.

We are predicting a downturn this time, peak to trough, of a little over 1 percent, which would be roughly the same as the mild recessions at the beginning and the end of the 1960s.

Senator EXON. Mr. Chairman, please indulge me for a moment. I am desperately trying to get to some conclusive points without getting bogged down in percentages and projection.

Let me ask the question this way. I take it that the CBO, in this instance, is making projections based basically on what has happened in the past. Has the CBO given any consideration whatsoever that this is not just another recession, like we have had in the past? That, indeed, this may be the beginning of a substantial reduction in the standard of living in the United States, given our spending patterns and deficit patterns in the past?

In other words, this might not be just one of those cyclical recessions that we have been through in the past. Maybe this is the downward turn that's going to be gradual. I take it from your position in your statement this morning that this is just another recession that we're going to bounce out of because it's very shallow; that it's going to be very short.

How much consideration have you given the fact that maybe this is not just another cyclical recession that we have been through before? In fact, maybe it's where we are going to have to begin to have to pay for our short-sightedness and failure to face up to reality over the long term. Is that possible?

Mr. REISCHAUER. I think that we have been paying for our short-sightedness and failure to save and invest over the decade of the eighties and even over part of the seventies. Our productivity growth has been very disappointing in this period. In making our forecasts, we have looked at the structure of the economy and taken into account the differences in the economy now as compared with other recessionary periods. There is certainly a good deal of fragility in the financial institution sector of the economy, and we took that into account. Alternately, there are things acting in the other direction, such as the importance of exports and world trade to the U.S. economy.

So, we do not just look at past recessions and say this one is going to be mild, let's pull a mild one out of history. We do this with very complex economic models that try and take into account all of the factors that concern you.

Senator EXON. Thank you. Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Exon.

Senator Grassley?

Senator GRASSLEY. Mr. Chairman, Mr. Director, I don't have any questions, but I want to take about 2 minutes to make a short statement, because a lot has happened since we last met that affects this committee and the budget process greatly. Unfortunately none of it is new.

We lowered the deficit by $500 billion over 5 years in our agreement but it grows by $50 billion before we even get back into session, so the deficit is a little bit like Houdini, nothing can contain it.

Evidently we are still fighting an up-hill battle. We're told now that we have another $80 billion to add because of an S&L bailout. We've also made an overwhelming commitment of people and resources to stabilize the Persian Gulf, and we have mounting costs as a result of that.

Our allies, meanwhile, are reaping an overwhelming share of the windfall benefits of us being there, in the Gulf, and yet, they have contributed very little to date to pay the freight on the cost of the operation over there.

Germany and Japan have contributed less than $1 billion total. And I want to give you my opinion, Mr. Chairman, that Germany and Japan are going to have to ante-up a heck of a lot more because I don't think the people of the United States, through their Congress, are willing to have a surtax to pay for this war.

While we're fighting the Iraqis over the Gulf, we are still in a prolonged war, here at home, against the deficits. And this deficit is a very formidable foe that we're up against and we've been about as effective against it as a couple of Scud missiles have been effective in the Persian Gulf effort.

Today, Dr. Reischauer tells us that we've had two consecutive quarters of declining GNP. In my view, Mr. Chairman, as soon as the resolution expressing all of this—which is meant to suspend the deficit targets—is received by our committee, we should vote it down and send it immediately to the Senate floor. Somewhere we have to take a stand against the deficit and this is a good place to start. I understand, Mr. Chairman, that you have taken such a stance and I commend you, in your opposition, to this resolution if my staff has reported correctly to me some statements you have recently made.

So I look forward to working with you this year, Mr. Chairman, and also with the Director, but I hope that this committee can make a very great difference like we did, earlier on in the last decade—but not so much recently—I hope we can function as a committee, and make a main difference in this effort to get the budget under control, the budget deficit under control.

Chairman SASSER. Thank you. Thank you, very much, Senator Grassley.

Senator Hollings?

Senator HOLLINGS. Thank you, Mr. Chairman.

Dr. Reischauer, my question will go to taxes and specifically, perhaps, to the idea of a value-added tax to start paying the bills. Let me give you the rationale behind this particular approach, and, in a sense, bag one buzzard right here at the very beginning.

Now, Senator Domenici says, that the issue is "pay as you go". I agree with that. But the Washington rhetoric is so alien to the reality around this town that, "here we go again" as President Reagan said. You used an expression, "biting the fiscal discipline bullet" last fall. That's pure poppy-cock, we didn't. You know it and I know it.

When we passed Gramm-Rudman-Hollings, it imposed discipline, and we said that the deficit would be reduced to zero.

You didn't answer the question. I can tell you what the answer was by the Congressional Budget Office. CBO said it would be zero

by 1991—the year we're in—under the original Gramm-Rudman-Hollings.

Then we met together over at the White House, at Christmas time in 1987, and said, no, we will slip it a year and the deficit will be $64 billion in 1991. Then we were talking last year, when the deficit was running $221.4, that we're going to have $40 billion in savings, and bring the deficit down to $100 billion, or $80-some billion.

Now, you've got in here a deficit of $327 billion in your December forecast. That's a target of $327 billion and add $50 billion-plus to that from Social Security, it would be $377 billion and then add Desert Shield to it and you're over $400 billion. So we're going in the wrong direction. We don't have any discipline. You have got the Federal Reserve Chairman running around saying, we don't need taxes. Now, why? I've looked at this problem, being in this predicament over the years, I know that interest costs are eating us alive—we've got fiscal cancer.

The debt now is $3.3 trillion and it's going up some $400 billion each year. I've put in new taxes here, at the beginning of January, to raise $17 billion but my interest costs will rise by double that amount, all to buy nothing.

My entitlements—we are not talking about cutting spending—are bound to grow, particularly in a recession, anywhere from $10 to $12 billion. My health costs are going to similarly grow, around $19 to $20 billion. Add on the $28 billion to $86 billion and you are way over $100-and-some-billion.

Now, you project an increase in revenues of $65 billion, so we will start January of next year wondering how in the world it's gotten, you know, another day older and deeper in debt?

So I come with a proposal to return us to a pay-as-you-go-basis—a way to get rid of this fiscal cancer and to start paying for the war. Indeed, I am pleased to note that in your previous incarnation with a private think tank—when you were more at liberty to speak your mind—you yourself endorsed the concept of a VAT tax. In fact, not only did you envision VAT as a means for tackling the deficits, you also suggested that VAT revenues could be used to finance the escalating costs of federal health care programs. Your thinking on VAT was well-considered and well-argued, and I commend you for it. I only regret that your current responsibilities have given you a case of lockjaw on the subject of VAT as a solution to the deficit. We got eight votes last year for a value-added tax. I introduced it 3 years ago and we got bipartisan votes in this Budget Committee. This Budget Committee has tried living in the real world and paying the bill.

But if we're going to start off on this idea that all we need to do is adhere to those summit targets and adhere to those caps, and don't start a new entitlement program unless you're going to pay for it, and all of that kind of nonsense—you know, given the reverence and sanctity of the budget agreement, as if it really solves the problem—that's nonsense. We've got to live in the real world and start paying our bills.

What is your comment about a value-added tax? [Laughter.]

Senator HOLLINGS. Because I happen to know the answer. You wrote it 2 years ago, 3 years ago on April 1988 in the Brookings Institute.

Mr. REISCHAUER. I would love to answer that, but my time is up. [Laughter.]

Let me have at least partially equal time to what went before your question.

Senator HOLLINGS. Surely.

Mr. REISCHAUER. I am not as pessimistic as you are with respect to the overall deficit situation. I agree with you 100 percent that what happened at the summit, and passage of the budget law at the end of the last session, did not solve the problem, but it certainly was a giant step in the right direction.

The deficit that we would be looking at today for 1991 would be lower than the deficit for 1990 if the economy had not weakened and if the savings and loan and commercial bank expenditures were not rising at a very rapid rate. Those expenditures are not necessarily associated with problems that are occurring today; they are the accumulation of the debris in this sector, the excesses in this sector over a 12-year period. We are really cleaning up a mess. So I think you can be relatively optimistic.

Senator HOLLINGS. Do you think we ought to pay for the war? My time is going to be up. Do you think we ought to pay for the war?

Mr. REISCHAUER. I think we first ought to find out what the real costs, the budgetary costs are going to be——

Senator HOLLINGS. Whatever it is, do you think we ought to pay for the war?

Mr. REISCHAUER. The costs might be relatively modest, in light of the numbers that I gave before.

Senator HOLLINGS. I think the record ought to show that Lyndon Baines Johnson put on a 10 percent surtax and when that did not completely pay for the Vietnam War, in 1968, we went over to the White House in December—George Mayhan and the others—we called up Marvin Watson and President Johnson said, yes, cut the budget another $5 billion. In the end, we gave a balanced budget, a $3.2 billion surplus, to Richard Milhous Nixon.

Now, that's where I'm coming from and not all these sophisticated rationales. You don't think we ought to pay for the war because it's going to be modest?

Mr. REISCHAUER. There was a very important difference between the situation facing Lyndon Johnson and the situation facing the Congress and the President today—namely that when the surtax was placed on in the 1960's the economy was operating at or above full capacity. There were tremendous inflationary pressures, and the surtax was put on to dampen excess demand in the economy. That is not the situation now. I am not saying that we should not——

Senator HOLLINGS. I agree with you and what about a consumption tax, rather than a surtax on income—a value-added tax?

Mr. REISCHAUER. Exactly what form of taxation should be used to pay for the goods and services that we are demanding is an issue, you know, for the Congress. There are reasons to advocate value-added taxes; there are reasons to advocate surtaxes on the income

tax; or conceivably, if we were thinking of paying for the involvement in the Gulf, we should have a temporary gasoline tax increase if oil prices fall substantially, as there is some possibility that they will after the end of hostilities.

Chairman SASSER. Thank you. Thank you, Senator Hollings.

Senator Domenici?

Senator DOMENICI. Thank you, Mr. Chairman.

Mr. Chairman, let me say I got in on the end of, my friend, Senator Hollings' statement and frankly, I couldn't disagree more with his statements that we did nothing last year and his continued indications that the way that he would solve the American economic woe is to put on new taxes. He can call them whatever he wants. He can call them value-added; but I have seen his proposals and I suggest to him that he is talking about his billions and billions of dollars of new taxes to be imposed on the American economy as a solution to the woes that he keeps talking about. And I believe he will be talking about them for 10 or 15 years. But I don't believe this Congress or the American people are going to have any more of that. There will be a lot of talk and he will use nice words so that we can't tell what his proposals are. But they are taxes. And they are big, and they are large, and we never put enough on, according to his analysis.

Now, I haven't said that before, but I've made a new promise this year. I'm just not going to listen to others say that we never do anything and that we would solve it all with taxes.

I don't believe there will be any new taxes this year. If anything, there will be some tax reductions and the biggest issue will be what to do to the Social Security Trust Fund, which we have now succeeded in taking off the budget. Since everyone wants it off, it will be off.

The issue will be, should we cut it—because it is a tax on middle America. For all of those who said tax reform that was passed by both parties up here hurt middle America, just look at the record. It is the social security incremental add-ons that were put on middle America, not the tax reform package.

So that will be the next issue; reduce the payroll tax and move towards a cash basis instead of the surplus accumulation. I don't use my words to say where I stand on this issue. I'm looking at it carefully since we have now achieved what everyone wanted and such a proposal can be passed by 60 votes up here. I am simply saying that this will be the next issue.

Now, I would like to ask you, did you hear Dr. Greenspan's testimony yesterday about the recession and, in particular, that the downturn was partially the result of consumers' activity and uncertainties that were brought on by the Gulf crisis and attitudes in their minds? And if so, do you agree with that?

Mr. REISCHAUER. I did hear that and that is similar to our assessment.

Senator DOMENICI. Similar to your assessment?

If the oil prices come down to where they were about 5 days ago, or 6 days ago, will that have a big positive impact on America's economic recovery—a major impact?

Mr. REISCHAUER. The ingredients of the recession have basically been mixed already, and the cake may not be in the oven but it is

difficult at this point to change the situation. We are likely to have two consecutive quarters of economic decline. A sharp reduction in oil prices would presumably be associated with an end to the conflict in the Gulf, which would, I think, bring about a resurgence of consumer confidence and business confidence; clearly, a lowering of oil prices would affect the consumer price index. So we would have an increase in disposable income just the same way that we had the opposite occur in the months of August, September, and October. It would be beneficial to the economy. We would see slightly stronger growth. But I think the basic forecast that we are in a recession would not be changed.

Senator DOMENICI. My last question has to do with the financial institutions of this country. We've gone through a major bailout with reference to S&L's and we are hearing a great deal about the need to reform, in a major way, the banking laws of this land.

Do you have any way of judging what we, as elected officials, are hearing from businessmen and women particularly from small and medium-sized firms: that it is very difficult to borrow money these days and that the rules and regulations have created such a frightening attitude among bankers that the only way you can borrow money is if you don't need it. Many are telling us that.

Do you have any way of measuring whether this is a serious situation and whether it is having a negative impact on America's economic growth?

Mr. REISCHAUER. That is certainly one of the great uncertainties about the current economic outlook. The aggregate data do not suggest a serious credit crunch in the sense that otherwise creditworthy borrowers are being turned away. But one really doesn't know. The data that we collect lag months behind the current date, so this is one of those things you find out about after they are really over.

I think the availability of credit is a concern. We should keep our eyes on it, but we should also be aware that to the extent that it is taking place, it represents an effort to strengthen financial institutions. Something good is coming from the bad, and I think the Federal Reserve Chairman is very much aware of this problem. He indicated yesterday, at least, that he was taking this possibility into account in his monetary policy.

Senator DOMENICI. Thank you, very much.

Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Domenici.

Senator Simon.

Senator SIMON. Thank you, Mr. Chairman.

First, if I may comment because I think this is the first time that Dr. Reischauer has appeared here since the death of his father, Ambassador Reischauer, who was one of the finest public servants I ever had the privilege of knowing. And your presence here, in public service, is a great family tradition.

If I may comment just briefly on the Domenici/Hollings exchange here.

Senator HOLLINGS. Would the gentleman just clear up one thing? I co-sponsored, Senator Domenici, back in December of 1989, Senator Moynihan's reduction of the Social Security tax, which you

voted against last year in this committee, and I am glad to see that you are joining us.

Thank you, very much.

Senator DOMENICI. I did not join you yet.

Senator SIMON. I assume I get an extra 60 seconds, Mr. Chairman?

Chairman SASSER. This exchange will not be on your time, Senator Simon.

Senator SIMON. All right.

I think we should not, in this country, whether it is the administration or Congress, or the American people, enter into any war situation where we pretend the only people who are going to make the sacrifices are people in Saudi Arabia and their families. And I think for both social reasons and for economic reasons that is not desirable policy.

We face a choice of whether we are going to face up to this thing and do it on a pay-as-you-go basis or whether we are just going to slip and slide by and say, let our children and grandchildren pay for it.

It is not simply the LBJ example. A great example is Harry Truman. We got into the Korean War and Harry Truman said, "let's increase taxes to pay for it." We came out of that Korean War without—believe it or not—an increase in the deficit or an increase in inflation. It was a gutsy thing for the President and the Congress to do.

What we're going to do, I don't know, but this committee ought to play a role in fashioning that policy. I do believe, as Senator Grassley has said, there should be burden sharing. Some of our friends ought to be more forthright in sharing that burden than they are now.

In terms of the deficit also—and I think that budget agreement, while I voted against it because there are some things that I don't like in it, including that 60 percent requirement for transfer which I think is going to haunt us before this whole thing is over—but it was, at least, some restraint.

The fastest growing item in this budget, by far, is interest. We have not gotten a hold of that at all, no matter what kind of fancy wrappings you put on it, that is still, as Fritz Hollings says, "that's the cancer that is eating us."

I, frankly, want to see this country—if we can send 400,000 people over to the Middle East and respond to a real need and I'm not suggesting that it isn't a real need—we also ought to be able to pull the resources of this country to respond to education needs, to health care needs that are very real needs in this country.

Now, after listened—one of the things that you have to do is to listen to us as we have——

Mr. REISCHAUER. I have been listening.

Senator SIMON [continuing]. All right. You talked about interest rates and that thing is just unbelievable, that growth of the gross interest rates.

You talk about 10-year Treasury Notes, 3-month Treasury Bill rates, but for many Americans that adjustable mortgage is tied to

prime rate; for a lot of developing nations, it is prime rate plus one or plus one and a half.

What's your projection of what's going to happen on the prime rate?

Mr. REISCHAUER. As part of our forecast, we do not project the prime rate. But to the extent that other interest rates are falling, one would expect the prime rate also to come down a bit.

Let me just elaborate on some of the discussion that you were involved in because I do not want to be misinterpreted on whether we should pay for the war or not. What I was simply referring to is the fact that the law of the land at this point, as embodied in the Budget Enforcement Act and the revisions to the Budget Act that were adopted last year, is that we will not pay for it. These expenditures were put aside. The maximum deficit amounts and the discretionary spending targets do not apply to them. Now, that may not have been a wise decision but it happens to be, at this juncture, the law of the land.

Senator SIMON. OK, if I can, before that light goes on here, if I can ask you this question then: From the viewpoint of sound economics in this country, if you were to make a recommendation to this committee, whether or not we should put it on a pay-as-you-go basis, and pay for this war that we are participating in, what would your recommendation be?

Mr. REISCHAUER. As you know, CBO does not make recommendations but——

Senator SIMON. I'm asking you personally, Bob Reischauer personally.

Mr. REISCHAUER [continuing]. Bob Reischauer rarely is personally invited to testify before you. Speaking in another capacity, wars probably should be viewed as investments—investments in the long-run peace and stability of the world and of our country—and as such, should be paid for over an extended period of time.

When we fought World War I, we did not say, we are going to pay for this as we go. The economy would probably have been in shambles had we done this. I——

Senator SIMON. If I may interrupt—and I recongize I am overreaching my time here—that's true for World War I; it's true for World War II. It is not true for the kind of an operation that we are in now. And when you say, it is investment, education is an investment in this country; health care is an investment in this country, but I want to see education and health care on a pay-as-you-go basis. And to the extent that we can do this for any armed conflict that we're in—unless it is just overwhelming—it seems to me it is desirable to do it on a pay-as-you-go basis.

Mr. REISCHAUER. On the basic principle that American taxpayers should be paying for the goods and services they are asking of their Government to a greater extent than we have in the past several decades, I could not agree with you more.

Senator SIMON. OK.

Mr. REISCHAUER. And I would not differentiate necessarily on that between defense spending and food stamps or whatever.

Senator SIMON. Thank you. Thank you, Mr. Chairman.

Chairman SASSER. Thank you very much, Senator Simon.

Let me just correct the record here, if I may. It is my recollection that in the budget summit agreement that was enacted into law, we did not say that we would not pay for Operation Desert Shield. What we did say is that we did not necessarily have to pay for it. Now, it is a question of semantics, but I think we ought to put that out there.

As I understand it, it is not that we cannot pay for it if we wish to do so. We leave the option open to pay for it if we want to, and I have a hunch, when we get right down to paying for it, we will not have many volunteers.

Do you wish to clarify something, Senator Simon?

Senator SIMON. Yes; just for a point of clarification. Does that mean, Mr. Chairman, that if we do not do anything, we are just going to fudge and get by without doing anything to pay for it?

Chairman SASSER. What it means is that we will put it on the cuff again. As I understood, I watched the Chairman of the Council of Economic Advisers, Dr. Boskin, on a television program the other day, and he simply said—he was asked how we would pay for it, and he said, well, we will borrow the money temporarily, and I suppose that is what we will do. We will borrow the money temporarily.

Senator Symms?

Senator SYMMS. Thank you, Mr. Chairman.

I want to first ask to put my remarks in the record at the beginning of the committee hearing, following Senator Domenici's remarks, at the appropriate place, and just summarize by saying that, in general, I agree with what Senator Domenici has said.

I think we should recognize that we are paying for the war if we are borrowing the money. We are obligated to make good on those debts. If anybody thinks that we are not going to have to pay for the war, they should know we are paying for it on a daily basis with higher interest costs. So there is no free lunch in terms of paying for it.

My question, rather than the issue of raising taxes on the American taxpayers, goes back to the question of burden-sharing. I happened to catch on CNN this morning that the Japanese have now come in with an additional $10 billion package for the war effort——

Chairman SASSER. In pledges, Senator.

Senator SYMMS. Pledges. That is my question. How much did they come in with previously, $2 billion, is that correct?

Mr. REISCHAUER. The Japanese, through December 30th, had provided the U.S. with $428 million in cash contributions and $206 million in in-kind contributions, for a total of $634 million. That was substantially below what they had agreed to pay for the calendar year 1990 effort, and my understanding is that they were going to provide the extra resources that they had promised.

I have not heard these reports about——

Senator SYMMS. The question I wanted to get to is how much have we had to pay? Do we think the Japanese commitment is a fair share? If the war is costing us half a billion dollars a day, how much is a fair target for the U.S. contribution, that we can use as a benchmark when this committee looks at the costs of the war.

Mr. REISCHAUER. I really could not comment on that at all, but I would also add that I think the half a billion dollars a day is a resource cost number, not an incremental budget cost number. By resource cost, I mean, as I explained earlier, that we are using up ordnance, we are losing planes that we may or may not replace, and those costs only become budget costs if we decide later to replace the expended supplies and equipment.

Senator SYMMS. So is that where the number of half a billion a day comes from, it is the cost of the expended ordnance?

Mr. REISCHAUER. Yes, plus the incremental costs of pay and fuel and things for which you really do have to pay, but I think these are very squishy numbers. It will be a long time before we have firm estimates of what the incremental costs associated with this operation are.

Senator SYMMS. What leverage do you see that we have in the Senate and in the Congress, in general, to be sure that the Japanese do participate in burden-sharing and pay their share, other than threats of tariffs or other things?

Mr. REISCHAUER. I think the Japanese are very interested in remaining good friends and good allies with the United States. They are a rich economy, and I think they will eventually contribute an appropriate amount.

Senator SYMMS. If, in fact, this pledge of $10 billion, $1 billion to the front-line states and $9 billion to the allied forces, for the war effort actually were realized in the next few months, this would be an extremely positive statement of good faith, I would think.

Mr. REISCHAUER. Very much.

Senator SYMMS. And it would be very helpful to our effort. Is there a facility for us to accept those monies through our treasury?

Mr. REISCHAUER. Yes; there is an account in which these contributions have been deposited for the last 3 or 4 months, so we do have the facility to accept them. The $10 billion figure that you mentioned might also include Japanese assistance to allied states in the form of economic aid.

Senator SYMMS. Well, they said $9 billion for the war effort and $1 billion for the allied states, the front-line states that are really suffering the most from the embargo and from the tragic impact of the war on the region.

I guess I would certainly agree with Senator Domenici, that I do not believe there will be any new taxes imposed this year, and I believe that we will reduce the payroll tax. And I am one of the cosponsors of Senator Moynihan's bill and have been since the inception. I think we also should reduce and reform our rate of taxation with respect to capital assets. It is badly hurting our economy.

I agree with much of what Senator Domenici said, and I normally do in this committee. However, I did not support the package last year because of the tax increase which I think was unwise going into a recession. The tax increase only further deepened the recession and, therefore, has increased the deficit by additional billions.

But I do think he is quite correct in saying we should not waive those budget reforms which are part of the package, which are the spending restraint and reforms, which I do support. And I certainly believe that it would be unwise for this committee to in any way

encourage the waiving of any of the restraints that were passed in the hope that they may hold back the rate of spending of the Congress.

Thank you, Mr. Chairman, I see that the red light is on.

Mr. REISCHAUER. Could I just make an observation about the Moynihan proposal to reduce payroll tax rates?

Chairman SASSER. Yes.

Mr. REISCHAUER. There has been a lot of concern around the table about the level of the deficit, and the pressure that this presumably places on financial markets and the effect it has on future economic growth in this country.

The Moynihan proposal, if adopted, would reduce revenues in 1992 by a little over $20 billion, increasing to roughly $50 billion by 1996. In other words, the Federal Government would have to borrow more from private financial markets.

Senator SYMMS. Or stop spending.

Mr. REISCHAUER. Well, you stole the final line from me. If this is not compensated by other tax increases or spending reductions elsewhere in the budget, we will push up interest rates, reduce saving and investment in this country, and hurt future standards of living.

Senator SYMMS. Thank you, Mr. Chairman.

Chairman SASSER. Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman.

Welcome, good to have you here. The numbers, as I see them, show a deficit target for 1991 of $327 billion; is that correct? That would be the gross deficit with social security out?

Mr. REISCHAUER. That is the deficit excluding the surplus in the social security accounts, before the adjustments that will be made in the President's 1992 budget proposal that will be released on February 4th. The new budget act set a series of maximum deficit amounts, but these will be adjusted twice—once in the President's 1992 budget proposal, and once in his 1993 budget proposal—for changed economic forecasts, for technical factors, and for conceptual and definitional changes. So that number will change.

Senator CONRAD. But the number that we have to work with right now would be the $327 billion? That would be the number that is——

Mr. REISCHAUER. That is for 1991. For 1992, if I remember, the law was $317 billion.

Senator CONRAD. All right.

Mr. REISCHAUER. I would expect both of those numbers to rise substantially after the President releases his budget.

Senator CONRAD. To rise substantially?

Mr. REISCHAUER. Right.

Senator CONRAD. Do you have some rough idea of what that would be?

Mr. REISCHAUER. I would not want to hazard a guess.

Senator CONRAD. Working on fiscal year 1991 and 1992, in 1991 the deposit insurance would be $91 billion, in 1992 $107 billion?

Mr. REISCHAUER. Those were our December estimates. As I said, we are in the process of putting the finishing touches on our new set of forecasts and budget projections. I think a number closer to

$100 billion for the 1991 figure would be correct, likely which would be less than that for 1992.

Senator CONRAD. And the social security surplus for those 2 years, $66 billion and $74 billion for 1991 and 1992, roughly?

Mr. REISCHAUER. I think $63 billion and $70 billion are the numbers.

Senator CONRAD. Could you tell us, what Desert Storm cost in 1991 that is part of this $327 billion deficit?

Mr. REISCHAUER. I think the answer to that is zero net, if, as I suggested, we have received $4.6 billion in cash contributions from our allies through December 31st. If we spent $4.6 billion in incremental added costs, that would be a wash in terms of the deficit. They would cancel each other out.

Senator CONRAD. But for 1991, for all of 1991——

Mr. REISCHAUER. For all of 1991, it would be a wash. Built into those numbers is zero net. But, in any case, they would be outside of the maximum deficit amounts by reason of the emergency provisions of the new budget process.

Senator CONRAD. Well, we can define it away, but the fact is it is still out there.

Mr. REISCHAUER. Correct.

Senator CONRAD. What I am struggling to understand here is what is really happening. We say this doesn't count and this is off over here and this isn't part of it, but——

Mr. REISCHAUER. When the books are closed at the end of this fiscal year, there will be some amount that is attributable to——

Senator CONRAD. But there is nothing in here, and that is really what I was struggling to understand.

Let me ask you this: In your judgment, what will be the growth of the national debt in 1991?

Mr. REISCHAUER. The debt should rise by roughly $300 billion.

Senator CONRAD. $300 billion.

Mr. REISCHAUER. That is like saying that the deficit will be roughly $300 billion for the current fiscal year.

Senator CONRAD. The external deficit that we are running in this country now, roughly $100 billion a year? External deficit.

Mr. REISCHAUER. Well, I think the merchandise trade deficit for the first 11 months of 1990 was $95 billion and another month will get it up to a little over $100 billion. Then there are the capital accounts that will swing it around.

Senator CONRAD. So roughly $100 billion. Can you tell me what are our interest rates in comparison to the other major money centers at this point, given the latest reductions?

Mr. REISCHAUER. I think German interest rates are a tad above those of the United States, and Japanese interest rates are slightly below those of the United States, although these gaps have narrowed considerably. It used to be that interest rates in the United States were substantially above those elsewhere, but with the reunification of Germany and the monetary policy that the Bundesbank has followed, interest rates in Germany rose rather substantially. Moreover, with the financial crises in the Japanese stock market and the effort of that government to moderate the increase in land prices, the Japanese have tightened monetary policy as well.

Senator CONRAD. Just let me conclude. We have an external deficit of $100 billion a year. We are adding to our national debt by $300 billion. And yet our interest rates are below or close to the other major money centers. Doesn't that tell you that we have a very significant economic vulnerability here?

Mr. REISCHAUER. I certainly agree that we have significant vulnerability. We are a nation that depends on substantial external borrowing to maintain its consumption patterns. If we were borrowing substantially from abroad to finance an investment boom that would lead to higher standards of living and a greater ability in the future to pay off the debt we are accumulating, one would not be worried about it. But that is not the case. We are basically financing a consumption boom through borrowing from abroad, and we depend highly on the rest of the world. Obviously, that is not a position anybody wants to be in.

Senator CONRAD. Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Conrad.

Senator Lautenberg?

Senator LAUTENBERG. Thank you, Mr. Chairman.

One observation. The red lights here have come to mean the same thing as traffic red lights. You don't stop; you just roll on a little faster. We appreciate that, and I appreciate the indulgence of my colleague from North Dakota, who was very circumspect in his observation.

Chairman SASSER. I am going to watch this red light on you, Senator.

Senator LAUTENBERG. Yes; well, I am the only one, Mr. Chairman. It is you and me against the world.

I want to discuss briefly burden-sharing. I have been very discouraged by the unwillingness of this fragile coalition to take a significant share of the burden for conducting the war against Iraq and to liberate Kuwait, as it has been identified.

I noticed, Mr. Chairman, yesterday's paper carried a story—just a little aside—about Saudi Arabia pulling back its front-line troops and stationing them behind our troops. This is on their soil, protecting their families, the sovereignty of their country, 300 billion barrels in reserve of oil; and I don't know whether you factor that times 20 or 30, but it comes to a lot of money, something in the trillions of dollars worth of assets. And we are debating and pulling and cajoling and coercing and squeezing and praying that they are going to pay their fair share. I think it is an outrage—first of all, the pledge of $3 billion and barely half of it met at year end.

Japan gets some 70 percent of its oil from the gulf area, and the issue arises whether or not we ought to put on a charge per barrel to help us defray some of the financial burden in addition to the family, personal, and emotional burden that Americans are paying and have to continue to pay.

I just wonder whether there is anything that we can do by way of structure to identify how shortchanged I think we have been by our "friends." I use that with a quotation mark at the end. I think we ought to set up an index, Mr. Chairman, that would fix these pledges at the time that they were made and then add an interest charge and just publish it every day and make sure that they understand that the burden has gone up.

I would ask our distinguished witness here today what means, if any, he can suggest to ensure that our allies contribute their fair share. You said that the Japanese want our good will, want to maintain our good will. They want to maintain our good markets. Beyond that I am not sure they care about a lot.

Is there anything that strikes you as a way to get these folks to pony up to pay their fair share of this cost?

Mr. REISCHAUER. The Congressional Budget Office really does not have expertise in that area. This is really a foreign policy issue, I think, more than anything else.

Senator LAUTENBERG. All right. Let's leave it. You are right, and I appreciate the position you are in.

As you examine the depth and the length of the recession that we are in, have you examined that from a regional standpoint at all? What is the impact of the recession in the Northeast, compared with other regions, in your view?

Mr. REISCHAUER. Every recession has regional impacts that are quite unequal. That was true of past recessions, of course, when we had spikes in oil prices that brought much of the industrial Midwest to its knees but at the same time boosted the economies of the oil-producing regions of this country.

We do not do regional forecasts, but it is clear that the East Coast, particularly New England, is suffering considerably more than the Midwest and parts of the Southwest. But one has to remember that those regions, particularly the Texas-Oklahoma regions, were quite depressed at a time when New England and the Northeast were in a tremendous boom.

Senator LAUTENBERG. How about the recovery prospects? I come from New Jersey, and I am obviously very interested in what happens in our local economy. But regionalizing it, do you see us participating in the recovery in a disproportionate way because of the position that we are in now?

Mr. REISCHAUER. The real question here, I think, is the extent to which the local economy depends on or contributes to exports. A lot of the exports in the United States come from the Midwest, the old Rust Belt, and, therefore, the recovery might help them disproportionately.

Senator LAUTENBERG. Mr. Chairman, if I might, since it is only you and me, may I have one last past-the-red-light opportunity? That is, in terms of burden-sharing, it is estimated that six major oil companies made $6 billion in profits in the last 3 months of 1990. That represents over $2 billion more than in the same period in the previous year. Would it be reasonable to ask them to take some share of the burden that the country is going through and look at a windfall tax and see what impact, if any, it would have on our ability to deal with our problems, or a negative impact on our recovery?

Mr. REISCHAUER. Remember that we do have a corporate income tax, and the oil companies will be paying some substantial portion of those larger profits in that form. I think you might want to ask yourself a number of questions before you start down that path. Suppose oil prices plummet to $12 a barrel—as some oil experts have predicted they might if there were a successful conclusion of the hostilities that involved little damage to productive capacity in

Iraq and Kuwait. Also suppose the government of Iraq was such that we allowed them to begin exporting immediately so you had a much lower oil price. Under that scenario, would you also want to provide tax relief when their profits plummeted? This is a roller-coaster. We have been on it before, and I think you want to be very careful about assuming——

Senator LAUTENBERG. Are the prospects better for $60 than $12, or $50?

Mr. REISCHAUER. I would say that the prospects for $15 oil are a lot higher than the prospects for $50 oil.

Senator LAUTENBERG. Thank you very much.

Chairman SASSER. Thank you very much, Senator Lautenberg. Thank you, Dr. Reischauer.

Our next group of witnesses, we have a very distinguished panel here this morning, and I am very pleased that they would appear before the committee and testify. It is a great pleasure this morning to have once again Dr. Benjamin Friedman, a professor of economics at Harvard University. Dr. Friedman is a summa cum laude graduate of Harvard University, with a degree in economics. Dr. Friedman earned his doctorate at Harvard, before joining the faculty there as a professor of economics.

He also has extensive hands-on experience in the public and private sectors. In addition to working in investment banking in New York, Dr. Friedman has served in various capacities for the Board of Governors of the Federal Reserve System, as well as the Federal Reserve Banks of New York and Boston.

He has written several books, including a definitive work of recent months, entitled "The Day of Reckoning." He has also published extensively, and we are delighted to have him here with us today.

Dr. Friedman is joined by Dr. Fred Bergsten, who currently serves as the director of the Institute for International Economics. Dr. Bergsten's career has included distinguished service in both the public and private sectors. And prior to joining the Institute for International Economics, Dr. Bergsten served as Assistant Secretary of the Treasury for International Affairs, as well as Assistant for International Economic Affairs at the National Security Council.

He has also served as a senior fellow at the Carnegie Endowment for International Peace, the Brookings Institution, the Council on Foreign Relations, and has been widely published as an expert in international economics. He has written some 17 books, which we find most impressive, because that might be one or two more than my colleague Pat Moynihan has written.

We are pleased also to have with us today Dr. Mickey Levy, who has been chief economist at CRT Government Securities since August of 1990. Before then, Dr. Levy was chief economist at First Fidelity Bancorporation, where he was an active member of the bank's Asset-Liability, Investment Policy, and Employee Benefits Committees.

Dr. Levy spent nearly 10 years as an economic researcher at the American Enterprise Institute and at the Congressional Budget Office. He seems to have survived that last experience relatively intact, and Dr. Levy is on the board of trustees of the Economic

and Social Research Institute. He is a member of the Shadow Open Market Committee, and we are very pleased to have him here today.

Gentlemen, I want to apologize to you for the lengthy question and answer period that went on before your appearance here today. I was particularly anxious to have all of the committee or as many here as possible to hear your testimony, because I felt it would be an educational experience for the members of the committee. Even though they are not here, their staffs are, and I see some stalwart members of the fourth estate are still in the audience here and I am sure they will report with their usual high degree of accuracy your remarks here today.

So, we will turn to you first, Dr. Friedman.

STATEMENT OF BENJAMIN FRIEDMAN, PROFESSOR, DEPARTMENT OF ECONOMICS, HARVARD UNIVERSITY

Mr. Friedman. Thank you, Mr. Chairman, for your warm welcome, and I also thank you for inviting me to present my views to this distinguished committee, as it considers the extraordinary risks and challenges, and I do mean that, as your letter of invitation put it, the vulnerabilities now confronting our Nation's economy.

If I may, Mr. Chairman, I would like to cover in my remarks now only a small portion of my prepared remarks, and respectfully ask that my full set of prepared remarks be entered for the record.[1]

Chairman Sasser. They will be included in the record, as if read in full.

Mr. Friedman. Thank you, sir.

Before proceeding, however, Mr. Chairman, I do want to take this opportunity to applaud your leadership and efforts and those of other members of this committee in working to achieve the deficit reduction agreement that you mentioned in your opening statement.

As I have indicated in my prepared remarks, the specific combination of tax and spending measures finally adopted was far from flawless. Moreover, compared to the scale of the now chronic fiscal imbalance that the Nation has inherited from the policies of the last decade, there should be no question of these measures having solved the problem. They did not.

But the budget agreement reached last October does represent a significant step in the right direction, and in this respect it stands in welcome contrast to the fiscal paralysis that for some years had hobbled all serious efforts to limit the government's drain on the national saving and the resulting impediments to our productive investment and our ability to compete internationally.

You and your fellow committee members who worked so hard to this end deserve the gratitude of all Americans who care about our country's future.

Let me also say at the outset, Mr. Chairman, that I fully support the position that both you and Senator Domenici stated at the outset of these hearings. On the basis of the information now in

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[1] See p. 56.

hand, I would not favor suspending the various limitations embodied in our existing budget legislation.

Given our ability to resist the current economic downturn by other means—a subject to which I shall turn shortly—and given also the carefully structured and quantitatively limited character of these restrictions as they apply in the current situation, leaving them in place seems a small price to pay as a sign that we have, finally, at least begun to place the Nation's fiscal affairs in order.

For the first time since the 1980's, the U.S. economy is now contracting. The sudden increase in oil prices following the Iraqi invasion of Kuwait sharply aggravated what was already a worsening stagflation problem. Even without higher oil prices, the business expansion was slowing and inflation was accelerating. Now business activity has turned sharply downward, and no one knows for sure just how severe the recession will be or how long it will continue.

The most likely prospect now appears to be a decline in output produced and incomes earned, and a corresponding increase in the number of willing workers unemployed, roughly comparable to the average of the other recessions our economy has experienced since World War II.

Our economy is more vulnerable, however, than the likely scale of the recession would normally suggest, and that is true even apart from the risks associated with the Persian Gulf War.

Extraordinary patterns of borrowing and lending during the latter half of the 1980's have left an unwelcome legacy of financial fragility. These developments have raised to an unusually worrisome degree the probability that the recession now underway in non-financial economic activity may lead to some kind of failure in the orderly functioning of the Nation's financial system.

In addition, the Federal Reserve delayed easing monetary policy long enough to fall well behind the momentum of the widening decline in spending, production and employment. Unless the Central Bank now lowers short-term interest rates substantially further, that decline is likely to continue for some time.

More importantly, the burden of stabilizing an economic downturn runs at cross-purposes with our bank regulatory authorities' current attempts to unwind as quickly as possible many of the poor credits extended during the latter half of the 1980's.

Even if the Federal Reserve does now lower short-term interest rates decisively, it is not clear that this action will soon make credit more available to would-be borrowers, and thereby stimulate business. Especially in light of the weak balance sheets that banks and other major lenders have inherited from the 1980's, the resulting likelihood of a protracted period of weak business activity raises the prospect of some kind of financial disruption that, unless checked immediately by government intervention, would further compound the downturn in the non-financial economy.

To be sure, the odds currently remain against such a disruption occurring.

Even so, the potential implication of such an outcome, including implications for the financial markets, for non-financial economic activity, and for the role of government in the financial system, are

sufficiently far-reaching, that even a 10 to 20 percent probability that this might occur warrants serious attention.

Perhaps the most important element in the U.S. economic situation today is not what has recently happened, but what has not. Despite accumulating evidence of economic weakness throughout the autumn, the Federal Reserve System did not forcefully ease monetary policy. Continuing concerns over the persistence of price inflation, made more worrisome by the rise in oil prices, apparently checked the Central Bank's customary eagerness to cushion any major decline in business activity.

Even after President Bush and the Congress finally agreed on the 5-year budget package that you mentioned in your remarks, Mr. Chairman, the Federal Reserve lowered the Federal funds rate merely from 8 percent to 7.75 percent. Since then, it has pushed this rate down to 6.5 percent or so, and has also used a reduction in reserve requirements to signal that it has at last begun to take the threat posed by the recession more seriously.

The real problem in this regard, however, is not high interest rates per se, but a stringency of credit brought about through what in other countries is sometimes described as financial policy. A fashionable view of the wave of highly levered transactions, in which so much of corporate America participated in the 1980's, is that many of the borrowing firms were, in effect, issuing equity dressed up to look like debt. Their doing so seemed to make sense for a variety of reasons, ranging from tax incentives to corporate organizational objectives.

At the same time, however, when banks, insurance companies and other regulated lenders acquired these claims, they took on what amounted to the exposure of equity investments. Now the value of those claims has fallen, as equity prices are wont to do from time to time, and both the lenders and the responsible regulatory authorities have rediscovered why there are usually severe limits on the amount of equities that thinly margined financial intermediaries facing capital requirements can hold.

The regulators are now trying to restore the vitality of banks' balance sheets as expeditiously as possible. Banks are complying, both by shifting their portfolios into higher quality assets and in some cases by shrinking the total size of their portfolios. Both sets of actions are clearly helpful from the narrow vantage point of individual banks in question, but they may prove counterproductive from the perspective of the economy overall.

In particular, these more conservative bank lending practices have restricted the availability of credit among business borrowers to all but the strongest firms, which in many cases have little need for bank credit, anyway, because they can readily turn to the securities markets.

The most immediate question raised by this current effort to restructure lenders' portfolios is what will happen if the economic downturn now in progress is severe enough in both extent and duration to erode lenders' balance sheets yet further. After all, a recession usually brings a significant decline in the typical operating company's earnings, and today many firms are sufficiently leveraged to have to devote a large share of their cash flow to interest payments. A sudden renewed increase in the price of oil as a conse-

quence of the Persian Gulf war would further sap the cash flows of many energy-intensive firms.

Given the weakness of banks' balance sheets, together with the current regulatory posture, a decline in economy-wide earnings that impairs the ability of a large number of borrowers to meet their obligations would also impair the ability of many lenders to extend credit.

At that stage, there would presumably be little choice, but for the responsible authorities to reverse, perhaps quite sharply, the direction of both monetary policy and bank regulatory enforcement. In both of these contexts, as in so many others, persisting for too long in the pursuit of valid policy objectives, after the relevant underlying economic conditions have shifted adversely, can prove counterproductive.

Why, then, do I not favor suspending our budget limitations at this time? A weakening economy, of course, is the worst time to reduce spending or raise taxes. Even those of us who have been outspoken advocates of deficit reduction have acknowledged, or should have, if they have not already, that at the margin, spending cuts and tax increases will depress business activity, at least for a while.

But if the Federal Reserve does its job correctly and continues to ease monetary policy, then after some time the expansionary effect of lower interest rates will offset the contractionary effect of lower spending and higher taxes.

In questions of economic policy, as in so many other areas of endeavor, delay is often costly. In this case, our failure to address the budget problem in 1985 or 1987 or even in 1989 has not only allowed the Nation's over-borrowing and under-investing to continue that much longer, but has also sacrificed the opportunity to take the necessary measures when the economy was far stronger. Now, the measures adopted amount to much less than what is fully needed, and even so, at first they will, to some small extent, aggravate an already weakening economic situation.

As I stated at the outset of my remarks, however, because the likely extent of this effect is sufficiently small and, importantly, because we do have other, in my judgment, more appropriate ways to cushion the current downturn, I do not favor suspending the budget limitations at this time.

Mr. Chairman, thank you for giving me the opportunity to present my views to the committee.

Chairman Sasser. Thank you very much, Dr. Friedman. We will return to you for some questions later.

[The prepared statement of Mr. Friedman follows:]

January 17, 1991

TESTIMONY BEFORE THE UNITED STATES SENATE

COMMITTEE ON THE BUDGET

Benjamin M. Friedman
William Joseph Maier Professor of Political Economy
Harvard University

Mr. Chairman:

Thank you for inviting me to present my views to this distinguished committee as it considers the extraordinary risks and challenges -- as your letter of invitation put it, the "vulnerabilities" -- now confronting our nation's economy.

For the first time since the early 1980s, the U.S. economy is contracting. The sudden increase in oil prices following the Iraqi invasion of Kuwait sharply aggravated what was already a worsening "stagflation" problem. Even without higher oil prices, the business expansion was slowing and inflation was accelerating. Now, business activity has turned sharply downward, and no one knows for sure just how severe the recession will be or how long it will continue. The most likely prospect now appears to be a decline in output produced and incomes earned, and a corresponding increase in the number of willing workers unemployed, roughly comparable to the average of the other recessions our economy has experienced since World War II.

Our economy is more vulnerable, however, than the likely scale of the recession would normally suggest. Extraordinary patterns of borrowing and lending during the latter half of the 1980s have left an unwelcome legacy of financial fragility. These developments have raised, to an unusually worrisome degree, the probability that the recession now under way in nonfinancial

economic activity may lead to some kind of failure in the orderly functioning of the nation's financial system. In addition, the Federal Reserve delayed easing monetary policy long enough to fall well behind the momentum of the widening decline in spending, production and employment. Unless the central bank now lowers short-term interest rates substantially further, that decline is likely to continue for some time.

More importantly, the burden of stabilizing an economic downturn runs at cross purposes with our bank regulatory authorities' current attempts to unwind, as quickly as possible, many of the poor credits extended during the latter half of the 1980s. Even if the Federal Reserve does now lower short-term interest rates decisively, it is not clear that this action will soon make credit more available to would-be borrowers and thereby stimulate business.

Especially in light of the weak balance sheets that banks and other major lenders have inherited from the 1980s, the resulting likelihood of a protracted period of weak business activity raises the prospect of some kind of financial disruption that, unless checked immediately by government intervention, would further compound the downturn in the nonfinancial economy. To be sure, the odds currently remain against such a disruption's occurring. Even so, the potential implications of such an outcome -- for the financial markets, for nonfinancial economic activity, and for the role of government in the financial system -- are sufficiently far-reaching that even a 10-20% probability that this might occur warrants serious attention. Specifying in any detail just what a disruption to the financial system would entail in the current context is problematic, however, both because of the lack of recent historical experience bearing on the question and because of the peculiar origins of the current situation in the historically atypical excesses of the 1980s.

Financial Stability in the Recession

Perhaps the most important element in the U.S. economic situation today is not what has recently happened but what has not: Despite accumulating evidence of economic weakness throughout the autumn, the Federal Reserve System did not forcefully ease monetary policy. Continuing concerns over the persistence of price inflation, made more worrisome by the rise in oil prices, apparently checked the central bank's customary eagerness to cushion any major decline in business activity. Even after President Bush and the Congress finally agreed on the five-year budget package involving both higher taxes and new restraints on government spending, the Federal Reserve lowered the federal funds rate merely from 8% to 7 3/4%. Since then it has pushed this rate down to 7%, and has used a reduction in reserve requirements to signal that it has at last begun to take threat posed by the recession more seriously.

The real problem in this regard, however, is not high interest rates per se but a stringency of credit bought about through what in other countries is sometimes described as "financial policy." A currently fashionable view of the wave of highly leveraged transactions in which so much of corporate America participated in the 1980s is that many of the borrowing firms were, in effect, issuing equity dressed up to look like debt. Their doing so seemed to make sense for a variety of reasons, ranging from tax incentives to corporate organizational objectives. At the same time, however, when banks, insurance companies and other regulated lenders acquired these claims they took on what amounted to the exposure of equity investments. Now the value of those claims has fallen, as equity prices are wont to do from time to time, and both the lenders and the responsible regulatory authorities have rediscovered why there are usually severe limits (for banks, zero under normal circumstances) on the amount of equities that thinly margined financial intermediaries facing capital requirements can hold.

The regulators are now trying to restore the vitality of banks' balance sheets as expeditiously as possible. Banks are complying both by shifting their portfolios into higher quality assets and, in some cases, by shrinking the total size of their portfolios. (On a seasonally adjusted basis, neither business loans nor loans to individuals have shown any increase since last spring.) Both sets of actions are clearly helpful from the narrow vantage point of the individual banks in question, but they may prove counterproductive from the perspective of the economy overall. In particular, these more conservative bank lending practices have restricted the availability of credit among business borrowers to all but the strongest firms, which in many cases have little need for bank credit anyway because they can readily turn to the securities markets. To make matters worse, because the decline in the Japanese stock market has imposed growing pressure on the capital positions of the major Japanese banks, these institutions' U.S. offices are no longer providing what previously amounted to a useful safety-valve function, accommodating many of the American borrowers who could not obtain credit within their traditional relationships.

The most immediate question raised by the current effort to restructure lenders' portfolios is what will happen if the economic downturn now in progress is severe enough, in both extent and duration, to erode lenders' balance sheets yet further. After all, a recession usually brings a significant decline in the typical operating company's earnings, and today many firms are sufficiently leveraged to have to devote a large share of their cash flow to interest payments. A sudden renewed increase in the price of oil, during or after a Persian Gulf war, would further sap the cash flows of many energy-intensive firms. Given the weakness of banks' balance sheets, together with the current regulatory posture, a decline in economy-wide earnings that

impairs the ability of large numbers of borrowers to meet their obligations would also impair the ability of many lenders to extend credit. At that stage there would presumably be little choice but for the responsible authorities to reverse, perhaps quite abruptly, the direction of both monetary policy and bank regulatory enforcement.

Wholly apart from the burdens that a situation of this kind would place on our policymakers' capacity to maneuver effectively through turbulent and unfamiliar events, such an outcome would carry serious risks of undermining the very goals that these authorities have been seeking to achieve in their actions to date. A sudden and massive easing of monetary policy would risk reliquifying the economy to such an extent as to validate, in advance, another round of stubborn price inflation once the current downturn ends. A sudden wholesale turn toward regulatory forebearance would risk encouraging lenders to assume still further problem credits, which might then require until well into the 1990s to work off of their balance sheets. (For how long after the LDC debt crisis broke, in 1982, did banks complain -- with some justification -- that they were being made to suffer the consequences of having made loans that the government urged them to undertake in order to recycle the flow of "petrodollars" that followed the 1973 and 1979 oil price increases?) In both of these contexts, as in so many others, persisting for too long in the pursuit of valid policy objectives, after the relevant underlying economic conditions have shifted adversely, can prove counterproductive.

In the meanwhile, the near-term effect of the current risk of a disruption to the financial system is not just a matter of whether such an outcome occurs but also of what impact the anticipation of it may have on the behavior of both financial institutions and nonfinancial businesses. When the potential adverse implications of a situation are sufficiently grave, even a 10-20% probability

that it may occur can be sufficient to spur unusual defensive actions. Will banks and other lenders become even more quality conscious than the regulators seek? Will securities firms shift their funding strategies to rely less on overnight and other very short-term financing arrangements? Will those operating companies that still have ample financial resources take actions that collectively amount to a flight to liquidity? In the event of war in the Persian Gulf, will international capital suddenly flow to U.S. banks? Or away from them? The only honest answer at this stage is that no one really knows.

Consequences of Higher Oil Prices

Rising oil prices have already worsened the U.S. economy's current predicament. If war comes in the Persian Gulf, the economic consequences would hinge, to a large degree, on what happened to the supply of oil, and hence to its price.

Rapidly changing prices of imported inputs like oil affect economic activity in two major ways. First, because the United States buys oil from foreign sellers, the higher price affects the U.S. economy as if it were an excise tax, directly reducing the purchasing power of U.S. businesses and consumers. For modest price increases, however, the resulting dampening of the overall demand for goods and services is fairly small. The United States currently imports just over 2 billion barrels of oil per year. A price increase of about $10 per barrel, from the $15-20 range before the Iraqi invasion to $25-30 more recently, is therefore equivalent to the imposition of a $20-25 billion annual excise tax -- not trivial, to be sure, but hardly major in a $5 1/2 trillion economy. If a war were to drive the price substantially higher, however, the effect would be correspondingly greater.

In addition to this direct reduction in demand, the experience of the 1970s and early 1980s suggests that sudden oil price increases also depress the demand for goods and services by increasing uncertainty among both businesses and consumers. The origin of the most recent episode in a military action, the ultimate resolution of which remains in doubt, makes this uncertainty all the greater under the current circumstances. Companies considering new capital expenditures will probably defer action, if possible, until they can reconsider the attractiveness of new machinery or facilities once they gain a better sense of the medium- to long-run price of energy inputs. Similarly, the sharp drop in reported consumer confidence that has already occurred is no surprise, and it presumably indicates a reduced willingness to spend out of current incomes. In response to the $10 per barrel price increase that has already occurred, overall U.S. demand for goods and services will therefore contract by more than what a $20-25 billion per annum excise tax alone would imply. A war in the Persian Gulf could either compound this depressing effect or soften it, depending on whether the resulting military outcome left the outlook for oil prices more or less uncertain.

Even more important than these effects on demand, however, is the role of higher oil prices in adversely affecting the economy's ability to supply goods and services as they are demanded. With a higher market price of oil, users must pay more not just for the 2 billion or so barrels that the United States imports each year but also for the approximately 2 billion barrels produced and consumed domestically. In time the prices of natural gas, and other forms of energy that are ready substitutes for oil, will also rise at least partly in parallel to the higher oil price. As a result, the U.S. economy will no longer be able to supply the same amount of goods and services as before, at the overall price levels that would have prevailed in the absence of the oil price

rise. Keeping production levels up to their previous growth path would imply faster inflation, while holding inflation to no more than its previous trajectory would require at least an episode of slower growth -- in the event, an actual decline -- in production.

As the responses to the 1973 and 1979 oil price rises demonstrated, this adverse shift in the economy's ability to supply goods and services is what makes oil price increases so perplexing. The standard relationships according to which inflation and recession are alternatives no longer apply. When the price of oil rises sharply, the economy can and usually does experience both faster inflation and a recession simultaneously. (Conversely, when the price of oil falls abruptly, as happened during the 1980s, the economy experiences slowing inflation along with rapid growth.) The chief question that has dominated the thinking of the nation's financial markets for much of the last two years -- that is, whether the more imminent threat is inflation or recession -- has therefore become irrelevant. If oil prices remain at their new levels, the answer is both. The same would be true, albeit more so, if a war were now to raise oil prices significantly further.

The Budget Agreement

Finally, what about the budget agreement? The set of tax and spending measures on which President Bush and the Congress finally agreed at the end of October can be construed, if viewed through appropriately colored lenses, to narrow the federal deficit over the next five years by some $400-500 billion compared to the deficit that the government would otherwise have run. This achievement is different, of course, from actually shrinking the deficit. No doubt a major part of the motivation for raising taxes and cutting spending in the first place was the realization that without such measures, the deficit --

and hence the absorption of private saving by government borrowing, and hence the drain on the nation's ability to invest, and so on -- would probably have grown steadily larger. Now, federal spending and revenues will begin to draw more closely into line, at least once the current business recession has ended.

In the last analysis, the aspect of this agreement that may prove most significant is the implicit shift from deficit limits to spending limits as a way of reining in the federal government. As the experience since 1985 under the Gramm-Rudman-Hollings Act has amply demonstrated, legislating deficit ceilings is not the same as actually keeping the deficit within them. The President and the Congress can simply agree to raise the previously legislated targets -- as they did with the 1987 revision of Gramm-Rudman, and again with the newly enacted budget package for 1991-95. Even more problematic is the demonstrated willingness of the responsible public officials to misrepresent the true deficit picture. A year ago, for example, the administration certified that the deficit for the 1990 fiscal year would fall within the applicable Gramm-Rudman ceiling of $100 billion (plus the allowable leeway of another $10 billion). Just last February, President Bush's budget statement projected that the 1990 deficit would be $124 billion and that this year's deficit would come within the fiscal 1991 Gramm-Rudman ceiling of $64 billion after only modest policy changes. In fact, the 1990 deficit (measured on a basis consistent with these earlier estimates) was $220 billion, and the administration now projects that without the tax increases and spending cuts contained in the new agreement, the 1991 deficit would be $293 billion (or $197 billion without the savings and loan bail-out).

In contrast to the deficit-limit approach, the spending-limit approach places ceilings directly on what the government can spend, and leaves open whether to finance that spending by taxes or by borrowing. Under the new

budget agreement, the Congress and the President have -- apparently for the first time -- adopted direct year-by-year limits on federal spending. After excluding spending for entitlements and for interest on the national debt, to which such limits cannot apply even in principle, these limits apply to about 40% of all federal spending. Moreover, the new limits will apply separately to three distinct categories of non-entitlement non-interest spending: defense, nondefense international, and domestic. Unlike under Gramm-Rudman, therefore, there is no longer an incentive for those who advocate additional spending in one area, but think other spending is too high, to play against the system by pushing for more spending on the programs they favor so as to exploit the consequent automatic cuts elsewhere.

While this conceptual change may ultimately prove far-reaching, the actual spending limits set for the next few years represent only modest real progress. The agreement supposedly generates $67 billion of defense savings over the next three fiscal years, but because these "savings" are calculated against a sharply rising hypothetical baseline, the agreed limit on defense spending declines only to $293 billion in 1993, compared to actual spending of $299 billion in 1990. Moreover, even these limits explicitly exclude the extra expenses of Operation Desert Shield. A war against Iraq, or even a further build-up of U.S. forces with no resolution of the crisis for some time, could easily convert what would have been a modest spending reduction into a very large increase. In a similar vein, the limit on international spending rises to $20 billion in 1993, while that for domestic spending rises to $222 billion, compared to actual spending in 1990 of $18 billion and $185 billion, respectively. All this may constitute progress, at least against some benchmark, but it does not amount to a major fiscal retrenchment.

The new budget agreement also includes a grab-bag of miscellaneous tax changes such as higher rates on gasoline, tobacco and alcohol products; an increase in the annual wage subject to the health insurance portion of the payroll tax; an increase from 28% to 31% in the marginal income tax rate for high-income taxpayers, together with a partial loss of deductions that makes the true rate more like 32%; a luxury tax on big-ticket consumer purchases; and an assortment of other nuisances. Taken all together, the resulting increase in revenues adds up to $146 billion out of a supposed $492 billion of overall deficit reduction over five years. This too does not amount to a large-scale retrenchment in an economy generating $5 1/2 trillion of product each year, but the effect is clearly contractionary.

A weakening economy, of course, is the worst time to reduce spending or raise taxes. Even those of us who have been outspoken advocates of deficit reduction have acknowledged (or should have if they haven't) that spending cuts and tax increases will depress business activity, at least for a while. If the Federal Reserve does its job correctly, and now meaningfully eases monetary policy, then after perhaps a year or so the expansionary effect of lower interest rates will about offset the contractionary effect of lower spending and higher taxes. But that is likely only because the budget agreement was "backloaded," with relatively little of the intended overall deficit reduction slated for the first year or two, rather than "frontloaded" as would have made more sense in a stronger economy.

In questions of economic policy, as in so many other areas of endeavor, delay is often costly. In this case, failing to address the deficit problem in 1985, or 1987 -- or even 1989 -- has not only allowed the nation's overborrowing and underinvesting to continue that much longer but has also sacrificed the opportunity to take the necessary measures when the economy was

far stronger. Now, the measures adopted amount to much less than what is needed, and even so at first they will aggravate an already weakening economic situation.

In the end, what President Bush and the Congress will have achieved with this hard-won agreement is likely to be primarily a matter of whether the new procedures that they put in place endure, and whether they or their successors follow this lead with new action after the next election. By at least halting the growth of the government's fiscal imbalance, which was beginning to grow explosively under the existing tax and spending policies, the President and the Congress took an undeniably important step. Making higher taxes in particular a significant part of the package required substantial courage. But a deficit that would still equal some 3% of the national income in 1993 even under the rosiest of economic conditions -- no recession, and real economic growth rising to 3.3% per annum while price inflation slows to 3.4% per annum (in both cases, on average over the next five years) -- can hardly be the end of the story.

Indeed, to the innocent outside observer this agreement seems intentionally designed to be revisited in the spring of 1993, when the President submits his proposed budget for the 1994 fiscal year. The implied target for the deficit exclusive of both Social Security and the savings and loan bail-out declines by only $7 billion per year on average through fiscal 1993, but then by an average $45 billion per year in 1994 and 1995, thereby suggesting that the real cuts are still yet to come. In addition, by then the economic assumptions on which the projections contained in the agreement are based will probably be so at variance with reality that, notwithstanding the analytic appeal of the new target for what amounts to the structural deficit, more and more responsible people will question the relevance of a budget target that can be met even though the actual deficit is far greater and the economy

is doing relatively well. Most importantly, the agreement specifies separate limits for defense, international and domestic spending only through fiscal 1993. For both 1994 and 1995, there is merely an overall ceiling for total non-interest non-entitlement spending. How to divide that total among the three major categories is left up to the President and the Congress when they take up the fiscal 1994 budget.

If the deficit reduction agreement reached after so much effort last year leads to more and better in 1993 -- when, with luck, business conditions will be far more conducive to tax increases and spending cuts than they are now -- then it will have been a job well done despite its many inadequacies when taken on its face. But if it merely provides a way to get through the next three years by pretending that the serious action will begin thereafter, it will have accomplished far less than what the nation was entitled to expect.

* * *

In conclusion, Mr. Chairman, I want to take this opportunity to applaud your leadership and efforts, and those of other members of this committee, in working to achieve a deficit reduction agreement that did ultimately prove acceptable to both President Bush and the Congress. As I have indicated, the specific combination of tax and spending measures finally adopted was far from flawless. Moreover, compared to the scale of the now-chronic fiscal imbalance that the nation has inherited from the policies of the last decade, there should be no question of these measures' having solved the problem. They did not. But the budget agreement reached last October does represent a significant step in the right direction, and in this respect it stands in welcome contrast to the fiscal paralysis that for some years had hobbled all

serious efforts to limit the government's drain on the nation's saving. You and your fellow committee members who worked so hard to this end deserve the gratitude of all Americans who care about our country's future.

Chairman SASSER. Dr. Bergsten?

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. BERGSTEN. Mr. Chairman, thank you very much also for your kind introduction.

I would start by noting that the American economy has been extremely sluggish now for almost 2 years. We hear proud references to 8 consecutive years of expansion, but those references mask the fact that since the first quarter of 1989—literally 2 years ago—growth has never exceeded 1.75 percent at an annual rate in any 2-month period. In a sense, the present recession is simply a culmination of that downturn.

My cardinal concern is that, whatever happens in the Gulf, the outlook is for continued "slugflation," or sluggish growth with continually rising prices. The recession may end, in the sense that negative growth may last only 2 or 3 quarters, but I see little prospect for any resumption of satisfactory economic growth. The reason is simple: Neither of the usual policy tools, fiscal nor monetary, in my view available to stimulate recovery and engineer the catchup growth that usually follows recessions in this country.

I, therefore, doubt the forecast given you by Bob Reischauer earlier this morning, when he talked about a resumption of solid growth later this year. I am much more skeptical. The only prospect for reasonable expansion, in my view, is an all-out effort to generate export-led growth, something that we observed noted in the past in Japan, Germany, Korea and other countries, but that we have never thought about here. In my view, that is the one "out" for the United States. It is available, but we need a new, much more aggressive, much more conscious policy to go after it, and I will address that in my remarks.

Let me first note some of the vulnerabilities in the economy—an issue you focused on in your request for today, I think quite properly. In my view, the chief vulnerability facing us is the absence of policy instruments to respond to the recession. The budget profligacy of the 1980's clearly forestalls any possibility of using fiscal policy to stimulate demand. We know that the budget deficit is now rising because of the recession itself, but fiscal policy, with your budget agreement of last fall, has turned restrictive. That is certainly proper and essential to permit an easing of interest rates over time, as well as for structural reasons and to preserve confidence in American economic management in a very fundamental sense.

I would, therefore, urge the Congress to resist any temptation to undo the recent budget deal. In fact, my guess is that you are going to need to mount another sizable attack on the budget deficit in the next year or two, but for the short run, fiscal policy per se, is tightening, and will intensify the economic slowdown.

Monetary policy is, thus, left as the major available tool, and that is where hopes are focused for getting us out of the recession. But neither, I think, should we expect the Fed to rescue the economy. One key reason is that underlying price pressures remain

worrisome, as indicated by the continued escalation, until quite recently, of both core inflation and unit labor costs.

A second key vulnerability of the economy also limits the scope for easing monetary policy, and Senator Conrad referred to this earlier. The United States continues to run an external deficit in excess of $100 billion annually. That means we must borrow about $10 billion per month from the rest of the world to keep our economy afloat, not to mention to avoid withdrawals of the $1.5 trillion of foreign money that has already been invested here.

Yet our interest rates in nominal, let alone real, terms have already dropped below those for short-term rates in every key money center abroad. Any further sharp reduction in U.S. interest rates could, therefore, produce a sharp fall in the exchange rate of the dollar, particularly if there should be any additional uncertainties generated by unexpected developments in the Gulf or any possibility of an unraveling of the budget deal.

If the dollar were to fall sharply, markets would reverse themselves and push interest rates up, in order to attract the essential capital inflow to finance our external deficit. Because inflationary pressures would be intensified by that drop in the currency, the Fed might even have to tighten monetary policy to avoid such an occurrence. The Group of 7, which met in New York earlier this week, simply has to be sure it has a contingency plan in place against a possible fall of the dollar, because that could be disastrous for our own economy and for the world as a whole.

The third key vulnerability of our own economy, namely, the fragility of our financial system that Professor Friedman emphasized, enters the picture forcefully at this point. Any rise in interest rates in the midst of a recession would, of course, create the most dangerous possible environment for an explosion of the financial crisis. That is another key reason not to suspend the budget deal. One result, I am afraid, in both the immediate future and over the medium run, would be higher interest rates, which would increase the risk of financial disruption. In addition, any rise in interest rates would mean that monetary as well as fiscal policy would be running in a direction opposite to the needs of the economy: they would be deepening and prolonging the recession.

Now, this financial fragility—and I agree with Professor Friedman about its critical importance—is clearly adding to investors' doubts, both at home and abroad, about the United States, and thus to the prospect that the dollar could fall sharply. Moreover, given the banks' understandable preoccupation with strengthening their balance sheets and building their reserves, they are unlikely to expand their lending very much, even if the Fed pushes interest rates down. I think Chairman Greenspan has recognized publicly now that the credit crunch has led to zero growth in the money supply for the last 3 months, despite the Fed's efforts to cut the costs of money considerably.

Here I guess I would differ a bit with Professor Friedman and his call for a further easing of money policy. I agree there should be some easing, but I doubt that it is going to have much effect in stimulating the economy. The Fed is essentially pushing on a string, and that is yet one more reason, perhaps the most compel-

ling one, why I think monetary policy cannot do much to counter the recession.

So I am afraid the chickens have in some sense come home to roost. We have eliminated the possibility of using fiscal policy to cope with a recession: monetary policy runs into these vulnerabilities that I have emphasized; and as a result I fear that we face prolonged "slugflation," even perhaps an unusually prolonged and deep recession, unless we can devise a new strategy in response.

Fortunately, I think such a strategy is available in the form of export-led growth. The other witnesses have mentioned the point. Bob Reischauer stressed the strength of exports as an element in the strengthening of the economy. I would carry it further and suggest that only if we emphasize export-led growth and work very hard to achieve it can we get even a modicum of satisfactory recovery.

The key to this strategy is that there is, at least for now, no world recession. That in itself is an unusual event, since in all previous business cycles since the 1960's the world economy has been in sync. This is the first time in almost 30 years that that is not the case, and that is lucky for us. Most of East Asia, Continental Europe, and a number of the oil-producing countries are likely to continue growing at a fairly rapid clip, providing growing markets for our sales abroad.

The exchange rate of the dollar has already fallen to a level at which American industry is highly price-competitive, and we have not yet begun to reap anything like the full benefits of the fall in the dollar that began in the middle of 1989. Moreover, slack domestic markets should push our firms to look abroad for markets, and this should add to export-led growth.

I think that improvements in our trade balance in real terms, which is what counts for GNP, could add at least a full percentage point or more to our real economic growth in each of the next 3 years, turning a sluggish performance into one that is at least reasonably acceptable, somewhere in the ball park of 2 or 2.5 percent per year, which is about all that our slowly expanding productive capacity can permit without adding to inflationary pressures.

We achieved such an improvement in the trade balance in 1988. The U.S. economy actually experienced export-led growth under somewhat similar circumstances in the late 1970's. Most of the shift toward export orientation, of course, has to be engineered by private firms in the U.S., but here I think there are some reasons to be optimistic, to set against the pessimism that normally surrounds discussions of the trade balance.

In real terms, we have cut our trade deficit by over $100 billion, from its peak back in the third quarter of 1986 to the recent trough in the fourth quarter of 1990. That was a 80 percent cut in the trade deficit in real terms. Exports of goods and services grew by an annual average of 14 percent from 1987 through 1989. In other words, once the exchange rate of the dollar came down from its ludicrously high levels of the early 1980's, and had a chance to play through to our competitive position, the improvement has been across the board in manufacturing. It is not just one or two sectors such as aircraft it is across the board. Therefore, I think there are

reasons to believe that we have a good shot at achieving export-led growth, if we devote our attention in that direction.

I will conclude my statement, Mr. Chairman, by suggesting six steps that are needed to do that, and I will just tick them off briefly. I would be happy to discuss them further, if you would like to do so.

First, it is essential to avoid any further rebound in the exchange rate of the dollar that would undermine American competitiveness prematurely. I think the Group of 7, at its meeting earlier this week, should have publicly indicated that it would resist any such rebound. That is certainly in the U.S. interest, and since the rest of the world wants to see our economy recover, they should go along with it.

Second, there is a longer-term point involved concerning the American business sector and exports. When you ask American firms why they do not invest more in export capacity, the reason they will frequently give you is that they have no idea where the exchange rate will be when those new plants come on-stream. In the early 1980's they saw the dollar jump, depending on your index, by 60 to 100 percent, pricing them out of world markets. New plants take 2 or 3 years to come on stream. Our potential exporters are worried that by that time the dollar will again be pricing them out of world markets. We, therefore, need a more stable, effective monetary system.

The Congress called for such a system in the Omnibus Trade Act of 1988, when it required the administration to come up with programs to support a competitive exchange rate for the dollar. I think the administration should take the lead and that the Group of 7 should at least go back to the reference range system for currencies that they had in place a couple of years ago. But I would also advocate going beyond that, to target zones or a more extensive system, to provide some assurance to business in this country that they can invest in export markets, and that huge currency misalignments will not come back to haunt us in the future.

Third—and this relates again to the burden sharing question—it is up to the key surplus countries abroad—Japan, Germany, and a few others—to make sure that their domestic economic demand keeps growing through this adjustment period. As I pointed out, there is no world recession now, but we have to make sure that continues, if the U.S. is going to be able to achieve export-led growth.

Fourth—here at home I would suggest that export expansion should become the focal point of American trade policy. This point also relates to American industry and its investment plans. If American industry thinks that world markets are going to close and protection is going to set in, they are not going to invest in export capacity. Indeed, they are going to invest abroad to get behind the foreign barriers. So it is absolutely crucial, in terms of American corporate expansion plans and creation of jobs at home, that the outlook be for an open trade policy. That is why successful completion of the Uruguay Round is critical. Although the prospects now look bleak, I think a successful outcome is still quite possible, though it may take longer than we thought. Efforts to maintain free trade through bilateral and other negotiations also

remain critical, in order to keep investment at home, rather than see U.S. firms go abroad.

Fifth—a related point—the administration and Congress need to work together to sharply expand the programs of the Export-Import Bank. Export credit is crucial in many markets, but most private banks in this country, reflecting the financial vulnerability we already discussed, are withdrawing from foreign markets rather than pursuing them aggressively. Our government support program for export credits is pitifully small, both in absolute terms and compared to our competitors. We need to beef it up enormously.

Eximbank's direct lending increased tenfold from 1977 to 1982 and contributed substantially to the export-led growth of that period—which restored a U.S. current account surplus. We could do it again and it needs to be on the agenda for both the Congress and the administration.

Finally, and also related, the administration and Congress need to take another hard look at the whole range of current policies and laws that impede American exports. We talk a lot about foreign barriers to our exports. But we need to think more about our own barriers to exports: excessive national security controls, foreign policy controls, short-supply controls. There is a whole range of such barriers in the form of domestic laws and policies, each motivated by worthy and defensible objectives, but not, heretofore, seen in the broad context of what they add up to in terms of hurting our trade position—and therefore, at this crucial point where export-led growth is our salvation, hurting our economy as a whole. That, I think, needs to be high on the agenda as well, for both the administration and the Congress.

My conclusion, Mr. Chairman, is that the economic outlook is quite worrisome. The economy is vulnerable on a number of counts, whatever happens in the Gulf. Neither fiscal nor monetary policy, I fear, can be deployed very effectively to stimulate recovery.

Fortunately there is an out—export-led growth. Much of the rest of the world continues to grow and to provide expanding markets for our products. National economic policy needs to make a maximum effort to exploit that opportunity. In my view, the main prospect for restoring at least a modicum of satisfactory growth here rests with the ability of the administration and Congress to help American industry do so.

Thank you very much.

Chairman SASSER. Thank you, very much, Dr. Bergsten.

[The prepared statement of Mr. Bergsten follows:]

THE ECONOMIC OUTLOOK FOR 1991

Statement by

C. Fred Bergsten*

Before the

Committee on the Budget
United States Senate

January 23, 1991

The Present Situation

The American economy has been extremely sluggish for almost two years. Proud references to "eight consecutive years of expansion" mask the fact that, since the first quarter of 1989, growth has not exceeded 1 3/4 percent at an annual rate in any three-month period. The present recession is the culmination of that downturn.

My cardinal concern is that, whatever happens in the Gulf, the outlook is for continued "slugflation"--sluggish growth with continually rising prices--for as far ahead as the eye can see. The reason is that neither of the usual policy tools, fiscal or monetary, is available to stimulate recovery and engineer the catchup growth that usually follows recessions in this country.

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* C. Fred Bergsten is Director of the Institute for International Economics. He was formerly Assistant Secretary of the Treasury for International Affairs (1977-81) and Assistant for International Economic Affairs to the National Security Council (1969-71). A more detailed treatment of the proposals made here appears in "Rx for America: Export-led Growth" in the January/February 1991 issue of International Economic Insights, the new bimonthly periodical published by the Institute for International Economics.

The only prospect for reasonable expansion is an all-out effort to generate export-led growth. Neither the Administration nor the Congress has launched any significant initiatives in this direction, however, and I will suggest a six-point program for doing so--beginning with actions that should be taken by the Group of Seven (G-7) industrial nations together, and by the Congress in the new session.

Vulnerabilities in the Economy

The chief vulnerability facing the economy is the absence of policy instruments to respond to the recession.

The budget profligacy of the 1980s obviates any possibility of using fiscal policy to stimulate demand. Indeed, even as the budget deficit rises further due to the recession itself, fiscal policy has turned restrictive (unless the costs in the Gulf turn out to be considerably higher than originally expected). This is both proper and essential: to permit an easing of interest rates over time, for structural reasons, and to preserve confidence in American economic management. I would urge the Congress to resist any temptation to undo the recent budget deal. In fact, I suspect that another sizable attack on the deficit will be needed within the next year or two. But fiscal policy per se will intensify the slowdown in the near term rather than help counter it.

Monetary policy, as usual, is thus left as the major available tool. But neither should we expect the Fed to rescue the economy. One key reason is that underlying price pressures

remain worrisome, as indicated by the continued escalation until quite recently of both "core inflation" and unit labor costs.

A second key vulnerability of the economy also limits the scope for easing monetary policy. The United States continues to run an external deficit in excess of $100 billion annually. This means that we must borrow about $10 billion monthly in new money from the rest of the world--and avoid any net withdrawals from the $1.5 trillion stock of liquid foreign assets that is already here--to keep our economy afloat. Yet our interest rates, in nominal let alone real terms, have already dropped below those in every key money center abroad. Data from the first three quarters of 1990 reveal that the capital inflow, while continuing, has shifted both toward much shorter term assets and toward uncertain sources geographically.

A further sharp reduction of US interest rates could thus produce a free fall of the dollar, particularly if additional uncertainties were generated by developments in the Gulf and/or the specter of an unraveling of the budget deal. Markets would then reverse themselves and push interest rates <u>up</u> sharply to attract the essential capital inflow. Because inflationary pressures would be intensified by the drop in the currency, albeit much less than in some past periods because of the present slack in the economy, the Fed might even have to <u>tighten</u> policy to reinforce this tendency. The Group of Seven (G-7) must be

sure that it has a contingency plan in place to protect against this possibility.[1]

The third key vulnerability of the economy--the fragility of our financial system--enters the picture forcefully at this point. A sharp rise in interest rates in the midst of a recession would create the most dangerous possible environment for an explosion of that crisis. This is a key reason not to suspend the budget deal: one result in both the immediate future and over the medium run would be higher interest rates, increasing the risk of financial disruption. Any rise in interest rates would also mean that monetary as well as fiscal developments were running opposite to the needs of the economy--thus deepening and prolonging the recession.

The financial fragility itself is also clearly adding to investor doubts about the United States, both at home and abroad, and thus to the prospect that the dollar could collapse. (The recent report of large Taiwanese withdrawals underlines this risk.) Moreover, given the banks' understandable preoccupation with strengthening their balance sheets and building reserves, they are unlikely to expand their lending very much even if the Fed pushes interest rates down. Chairman Alan Greenspan recognized publicly last week that the "credit crunch" had led to zero growth in the money supply for the last three months despite the Fed's efforts to cut the cost of money considerably. The Fed

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[1] By contrast, as noted below, a modest and orderly further decline of the dollar could help support the proposed strategy of export-led growth.

is pushing on a string, yet another reason why monetary policy cannot do much to counter the recession.

In essence, the chickens have finally come home to roost. Our policymakers largely ignored the budget deficit for a decade and the recent deal, while representing an enormously important first step in the right direction, has hardly solved the problem. The past and current Administrations have blithely accepted the huge trade deficit and our growing dependence on foreign capital. The financial system has been permitted to deteriorate. As a result, we face prolonged slugflation--and perhaps an unusually deep recession--unless we can devise a new strategy in response.[2]

Export-Led Growth

Fortunately, such a strategy is available: export-led growth. There is no world recession. Most of Asia, continental Europe, and a number of oil-producing countries are likely to continue growing at a fairly rapid clip. The dollar has fallen to a level at which American industry is highly price-competitive--and we have yet to reap anything like the full benefits of its substantial decline since mid-1989. The slack domestic market should push our firms to look abroad for markets.

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[2] It is conceivable that a successful resolution of the crisis in the Gulf would spur some renewal of growth by leading to lower oil prices and by eliminating some of the uncertainties that are now deterring both investors and consumers. The underlying problems identified here would remain, however, and it is difficult to foresee a sustained recovery until they are addressed.

6

Export expansion--more precisely, improvements in the trade balance in real terms including a reduced share of the domestic market captured by imports--could add a full percentage point or more to American economic growth for the next three years. Similar improvement was already recorded in 1988, and our economy actually experienced export-led growth under somewhat similar circumstances in 1979-80. In the process, such trade improvement would wholly or largely eliminate the current account deficit in nominal dollar terms--ending our dependence on further inflows of foreign capital and thus reducing considerably one of the key vulnerabilities facing the economy that was discussed above.

Most of the shift toward export orientation must of course be engineered by private firms in the United States (including the American subsidiaries of foreign companies). Such a shift was in fact achieved in the late 1970s and the export boom of the past four years--since the dollar declined after the Plaza Agreement of 1985 to levels that began to restore American price competitiveness in world markets--augers well for further progress. Japanese firms successfully made the opposite shift, from export orientation to the domestic market, in about a year after the yen doubled in value against the dollar in 1985-86.

However, about 85 percent of American exports are still accounted for by only 15 percent of our companies. Only 20 percent of the firms that do export are active in more than five markets. Hence there is enormous scope for further expansion.

7

The United States Government must help achieve this reorientation, however. American economic policy should attach priority attention to supporting export-led growth. Six steps are needed.

First, it is essential to avoid any further rebound in the exchange rate of the dollar because such a shift would undermine American competitiveness. The Group of Seven should publicly indicate that it intends to resist any such rebound.[3] If the dollar were to decline by a further modest amount in an orderly manner and in response to market forces, as seems likely in light of lower interest rates and expansion here than abroad, export-led growth would be promoted and such a move should thus be welcome to both the United States and the G-7.

Second, it is also essential to assure American industry that it can invest and plan for export markets for the longer term. Many firms hesitate to do so because they fear that the dollar could soar again during the next few years and price them out of world markets, as it did during the period of "benign neglect" during the first Reagan Administration in the early 1980s. The present Administration should thus indicate its clear intention to sustain the dollar at competitive levels, as mandated by the Omnibus Trade and Competitiveness Act of 1988. It should also work with its G-7 colleagues, building on the

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[3] Similar statements were issued in 1989 but came far too late as the dollar had already bounced back sharply from its end-1987 lows, slowing the export recovery and causing some of the renewed deterioration in the trade balance that--with the usual lags--has showed up in recent months.

"reference ranges" for currencies that were adopted in the Louvre Agreement in 1987 and maintained for a couple of years, to install a credible and effective system of target zones that would prevent such misalignments in the future.

Third, the key surplus countries--notably Germany and Japan--should maintain rapid rates of economic growth, led by domestic demand (and thus further declines in their external surpluses), throughout the adjustment period. Japan has implicitly pledged to do so through committing itself in the Structural Impediments Initiative (SII) talks to large increases in government infrastructure spending over the next ten years. The key requirement for Europe is to work out a revaluation of the DM within the European Monetary System to stop Germany from exporting recession to the rest of the EC, as it now threatens to do via the extremely high interest rates that are emanating from the huge budget deficits triggered by unification. These issues too should be on the G-7 agenda.

Fourth, export-led growth should become the focal point of American trade policy. In this context, it is imperative to achieve a successful conclusion of the Uruguay Round of multilateral trade negotiation--which is by no means impossible, despite the current pessimism, albeit perhaps over a longer time period than heretofore envisaged. It is essential to achieve a reduction of barriers in sectors where the United States has a competitive advantage to encourage American firms to reorient to export markets. They will clearly not do so if they fear a

breakdown of the open trading system. Indeed, they would then invest abroad to hedge against the creation of new foreign barriers and the intensification of bloc trading.

Fifth, the Administration and Congress need to agree on a sharp expansion in the direct lending program of the Export Import Bank. Export credit is crucial to sales in many markets but most private banks in this country--reflecting the broader vulnerability cited above--are withdrawing from foreign markets rather than pursuing them aggressively. Our government support program in this area is incredibly small and even ran totally out of money in mid-1988 during an export boom when much further progress was needed.

Eximbank's direct lending increased tenfold from 1977 to 1982 and contributed substantially to the export-led growth of that period--which restored a surplus in our current account position and strengthened America's position as the world's largest creditor country. A similar expansion is far more essential now that we are running a massive external deficit, are the world's largest debtor country, and need trade improvement to restore a reasonable modicum of economic growth.

Finally, and closely related, the Administration and Congress should work together to remove the many impediments to exports that remain embedded in US law and policy. The nation is losing billions of dollars worth of exports annually through excessive controls for national security reasons (despite the end of the Cold War), foreign policy reasons (despite the sale of

similar products by other countries), short supply considerations (such as for Alaskan oil) and a host of other purposes--each of which may be worthy, in and of itself, but most of which have simply not been considered in the contemporary context in which export expansion has become a national imperative.

Conclusion

The economic outlook is extremely worrisome. The economy is vulnerable on a number of counts, whatever happens in the Gulf. Neither fiscal nor monetary policy can be deployed to stimulate recovery. Indeed, the former is already (albeit necessarily) intensifying the downturn and the latter could easily shift in that direction.

Fortunately, there is an "out": export-led growth. Much of the rest of the world continues to grow and thus provide expanding markets for our products. National economic policy needs to make a maximum effort to exploit that opportunity. The main prospect for restoring at least modest growth rests with the ability of the Administration and Congress to help American industry do so.

Chairman SASSER. Dr. Levy?

STATEMENT OF MICKEY D. LEVY, CHIEF ECONOMIST, CRT GOVERNMENT SECURITIES, LTD.

Mr. LEVY. Mr. Chairman, I sincerely appreciate this opportunity to speak before your committee. My written comments were prepared before January 15, and while the war will certainly have an impact on the economy, it's very important to consider the economic fundamentals that led up to the Middle East War.

The primary thrust of my remarks are as follows: The current recession or correction is very unique in its profile, both in terms of how the economy has slowed gradually and because there is a large variance of economic performance across different industries, and across different regions in the nation. This has created a near reversal of the mix of industrial performance compared to recent recessions.

Consequently, the debate today about whether the recession will be "mild" or "severe" based only on the magnitude of the decline in real GNP is grossly over-simplified.

In 1989–1990, even though real GNP continued to grow, recessionary-type conditions unfolded that normally occur when real GNP is declining. One Senator mentioned that we are entering a recession. One could argue we've been in it, and GNP revisions may reveal that.

The worst news about the economy, I believe, has already occurred. After a sharp decline in real GNP in the fourth quarter of 1990, I expect a rather flat first half of 1991 and then a gradual rebound. Associated with the economic weakness, I expect inflation to fall significantly in 1991–1992; I am more optimistic about inflation than either the Administration, the CBO, or the Federal Reserve.

Despite many weaknesses in the budget accord of 1990, I believe it is imperative that the Senate fully implement the Budget Enforcement Act and not vote to suspend it. I encourage the Budget Committee, in addition to addressing the budget deficit, to refocus the fiscal debate and place more emphasis on the mix of spending, the structure of taxes, the economic responses to them, and what they imply for the allocation of the nation's resources.

Finally, I applaud the Federal Reserve's disinflationary monetary policy goal, but I strongly recommend that the Fed loosen its rigid targeting of the Federal funds rate and pay more attention to bank reserves and money supply. It should take the immediate steps to raise money growth close to the mid-points of the Federal Reserve's target ranges.

There has been some discussion about the Fed "pushing on a string", implying an inability of monetary policy to affect the economy. This statement is usually made when the economy is sliding and interest rates are declining in response to deteriorating economic conditions. Over the last 3 years, the Fed has not eased in terms of the monetary aggregates. Interest rates have come down as a reflection of deteriorating conditions. There has been no growth in liquidity in the economy in 3 years. The Fed is still tight.

When it eases and money growth picks up, monetary policy will stimulate product demand and the economy.

Nominal and real GNP growth slowed gradually in the 2 years leading up to the expansion peak. This is very atypical. A typical recession has a V-shaped pattern wherein the Fed is too accommodative for too long and then slams on the brakes, generating a sharp downturn and then opens the monetary floodgates. The Fed has been tight for several years, and it remains restrictive. This has depressed domestic demand growth, and at the same time, export growth has slowed.

I expect a gradual economic rebound because I expect the Fed to stick to its disinflationary policy, allowing rates to decline gradually but not pumping up domestic demand growth.

Importantly, in addition to the cyclical decline in aggregate activity we have experienced over the last 2 years, recent economic conditions have been significantly affected by an ongoing structural shift in the mix of output. Since mid-1986, when the real trade deficit peaked coincident with the peak ratio of consumption—to—GNP, exports have been rising sharply as a share of GNP, while retail sales and consumption, residential investment, and government purchases have declined as shares of GNP.

This shift has been dramatic: Controlling for the level of GNP, there has been a shift towards exports of $175 billion. Retail sales and consumption have been declining as shares of national output. Department stores have been doing poorly and exports are doing well. Residential construction is doing poorly. This major shift in the structural mix of the economy will continue regardless of what happens to the level or rate of growth of GNP.

This shifting mix is having a marked impact on economic performance by industry and by region in the nation and is contributing to the very unique profile of the economic correction. During typical recessions, manufacturing industries underperform, while this time around, manufacturing firms will outperform. Historically, during recessions, most service-producing industries move along sideways and out-perform. This time around, several key service-producing industries are underperforming and undergoing major restructuring—particularly, retail trade and financial services. Real estate, following its typical cyclical pattern, is declining.

Reflecting this structural mix and the regional reliance on certain industries, the economics on the eastern seaboard are underperforming, while the midwest is outperforming. This reflects in part the fact that exports are rising as a share of GNP.

Importantly, while real GNP grew in 1989–1990, recessionary-type conditions unfolded that usually occur when GNP is declining. For example, corporate profits declined sharply; interest rates declined sharply; real estate, both in terms of prices and output, declined significantly; business inventories declined and businesses cut operating expenses; credit quality deteriorated; there were more business failures; and bank problems emerged. These types of characteristics have never occurred at that analogous stage of economic expansion. They have always occurred during recession.

What this suggests to me is that many excesses in the economy that typically are eliminated during recession are already dissipating, and the worst economic news may have already occurred.

I expect real GNP to be flat in the first half of the year. I might note, the difference between a .5 percent quarterly increase in real GNP and a .5 percent decline is pure and simple statistical noise, and none of us can discern the difference until after the fact. The economy is very weak.

Even if real GNP is flat, exports will continue to rise, while the financial services, retail trade, and real estate industries will continue to fall. I might note that the economic under performance on the east coast has significantly affected perceptions by east coast analysts and the press about the severity of the downturn.

In Cleveland, Chicago, or major export-oriented regions, businesses are not hurt as much by the national recession; even in Senator Lautenberg's State of New Jersey, the big exporting pharmaceutical firms are experiencing healthy growth. This merely illustrates the big change in the mix of output.

Monetary policy remains restrictive. As illustrated in a chart in my written testimony, in inflation-adjusted terms, there has been no growth in money supply for 3 years. The federal funds rate is a policy lever of the Federal Reserve, but it also reflects demand pressures associated with economic conditions. Federal funds rates have come down 300 basis points since Spring 1989, but that decline has reflected subsiding demand pressures associated with deteriorating economic conditions, and has not involved any increase in liquidity. So although some people think the Fed is pushing on a string, monetary policy remains tight. I see no reason why, if the Fed did start to pump liquidity in to the system, with a lag, you would see a pick-up in product demand and the economy.

In response to the general concern about consumption, I would say economic performance in 1991 hinges more so on exports than domestic consumption. Domestic consumption tends to vary by only small amounts during recession. It is usually investment and inventories that decline during recession. With tight monetary policy and declining domestic demand, it is very important exports continue. Consequently, I consider economic growth in Germany, France and Europe to be very important to economic prospects in the United States. Nevertheless, I disagree with attempts to lower the dollar to encourage exports.

With regard to the banking industry—having spent years in banking—my strong belief is that the problems in the banking industry, including tight lending standards and the declining bank loans, are more of a reflection of the deteriorating economic conditions—slumping credit demand, and declining credit quality—than a constraint on total credit supply. Therefore, the widely publicized problems in banking are not as much a cause of the current economic slump as a symptom, and as such, they will not constrain future economic expansion.

As economic performance deteriorated in 1989–1990, domestic banks, particularly those on the east coast, were over-weighted with assets of declining industries. As bank lending has declined, other sources of credit have increased. So credit is still available, but there has been a change in the sources of credit. There is a micro-based credit crunch, with credit being reallocated from declining industries to rising industries, which is good news.

I concur with the CBO's assessment that the budget accord should be fully implemented and that the sequestration not be suspended. I would add that fiscal policy is much more complex than just the size of the deficit.

Policy makers should pay more attention to the mix of Federal spending, and what it means for the allocation of the nation's resources. The deficit does have significant impacts, particularly in the long run, but its effects depend very importantly on the mix of spending, the burden of taxes, and how businesses and households respond.

Finally, fiscal policy and monetary policy have very different economic impacts in the short run and the long run. Efforts to achieve a "desired mix" in fiscal/monetary policy can be very dangerous.

Finally, I strongly encourage the Federal Reserve to relax its very rigid targeting of the Federal funds rates and to immediately take the steps to raise money growth up towards the middle of the Fed's targeted bands. This would involve lower interest rates. The Fed should not target interest rates because they reflect economic conditions. Targeting bank reserves and money growth would yield the most effective monetary policy.

Thank you.

Chairman SASSER. Thank you, Dr. Levy.

[The prepared statement of Mr. Levy follows:]

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A PERSPECTIVE ON ECONOMIC CONDITIONS AND MACROECONOMIC POLICIES

Testimony of
Mickey D. Levy
Chief Economist
CRT Government Securities, Ltd.

Committee on the Budget
U.S. Senate
January 17, 1991

A PERSPECTIVE ON ECONOMIC CONDITIONS AND MACROECONOMIC POLICIES *

Testimony of
Mickey D. Levy
Chief Economist
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Mr. Chairman and members of the committee, I appreciate the opportunity to present my views on economic conditions and macroeconomic policies. My remarks today will focus on the unique profile of this economic correction and the outlook for future economic performance, and what I believe are proper fiscal and monetary policies in the current economic and budgetary environment.

In summary, the profile of this correction is distinctly different than recent recessions, both in its cyclical pattern and in the industrial mix of the adjustment. In contrast to the typical "V" shaped recession, in which a sharp decline in real GNP is followed by a powerful rebound, the persistent monetary tightness since 1987 and the slower growth of exports in 1989-1990 have generated a gradual economic slowdown since late 1988. Following a significant decline in real GNP in fourth quarter 1990, I expect real GNP to be relatively flat in the first half of 1991, rather than continuing to fall sharply. If the Federal Reserve continues to allow a gradual decline in the federal funds rate, and does not shift aggressively toward monetary ease, the economy will rebound in the second half of 1991 and continue to expand in 1992.

In addition to the cyclical pattern of slowdown, a structural shift in the mix of

* Prepared for the Senate Budget Committee, January 17, 1991

economic output that began in 1986 will continue, with exports rising as a share of GNP, while the shares of retail sales and consumption, government purchases and real estate decline. Consequently, the manufacturing industries will outperform during the correction, while certain service-producing industries, particularly financial services, retail trade, and real estate, are underperforming and restructuring. This mix will continue in 1991-1992 whether real GNP rises or falls. It is having its largest negative impact on the east coast and on the financial services industry. Problems in the banking industry are more of a reflection of deteriorating economic conditions rather than a constraint on total credit, and are not constraining *aggregate* economic activity.

The silver lining in the outlook is that core inflation, which is below previous expansion peak levels, will fall gradually but significantly in 1991-1992, and some of the excesses in the economy have already been dissipating. This lessens the extent of further decline and will create a strong foundation for healthy economic growth in the 1990s. Beside the mideast crisis, the largest risk to the economy is exports, whose continued growth hinges critically on future economic expansion in other industrialized nations, particularly those in Europe.

Maintaining fiscal discipline and credibility requires, at a minimum, full implementation of the spending constraints imposed by the Budget Enforcement Act of 1990. If given the chance, Congress should vote to maintain the Gramm-Rudman-Hollings sequestration process. Prudent fiscal policy presently involves avoiding costly increases in discretionary spending designed to counter the economic cycle. As important as the deficit is, however, Congress must pay more attention to how the tax and spending structures underlying the deficit determine and influence the allocation of national resources. This requires placing more emphasis on desirability and implications of the mix of federal spending, the tax structure, and the economic and financial responses to changes in them, and how they influence the mix of economic output and long-run growth.

The Federal Reserve is encouraged to maintain its long-run disinflationary monetary policy, but relax its procedure of rigidly targeting the federal funds rate, and take the necessary steps to bring growth of the monetary aggregates closer to the midpoints of the Fed's target ranges. This would involve declines in short-term rates. Aggressively easing monetary policy would generate a rapid rebound in domestic product demand, but would be inconsistent with the long-run goals of low inflation and maximum economic growth, and should be avoided.

Economic policymakers must be aware of the proper roles of fiscal and monetary policies, their respective limitations, and how to best achieve the desired goals of healthy, sustained economic expansion and job creation. Monetary policy should be implemented to achieve long-run stable prices, while fiscal policy should be geared toward encouraging productivity through public investment in infrastructure and private investment in plant, equipment, and facilities. Monetary policy is an aggregate demand tool that should not be used to try to smooth industrial or regional disparities in economic performance, or structural shifts in the economy. Fiscal policy has a significant impact on the allocation of national resources and economic incentives, but has proved to be an ineffective and unreliable tool of aggregate demand management. Efforts to achieve a desired "mix" of monetary and fiscal policy, which are based on the incorrect notion that they are substitutes for achieving the long-run objectives of economic growth and stable prices, are misguided and potentially dangerous.

(1) Nominal and real GNP growth slowed gradually in the two years leading up to the current economic expansion peak (third quarter 1990), in sharp contrast to the relatively abrupt shifts from expansion to recession that characterized most recent downturns. Growth of consumption and domestic demand slowed in 1989-1990 in response to the persistently restrictive monetary policy since 1987, and export growth moderated. Since 1987, real M2 has not increased (See Chart 1). In contrast, the Fed remained overly accommodative during mature stages of recent expansions, generating high and/or rising nominal GNP growth, and then slammed on the monetary brakes, generating a sharp fall in product demand growth. Not only has nominal growth decelerated slowly, but its 5.3 percent growth rate from third quarter 1989 to third quarter 1990 was substantially slower than the year prior to any recent recession (See Chart 2).

The gradual slowdown in product demand has allowed businesses to adjust production and keep inventories at generally low and manageable levels. In contrast, at previous expansion peaks, abrupt declines in product demand growth generated large stocks of undesired inventories that required major cutbacks in production.

Nominal growth is only modestly above the nation's long-run capacity to grow, and its slowdown in 1989-1990 is beginning to unwind the excesses and bottlenecks that generate inflation pressures. This is a significant advantage of the current economic situation relative to recent expansion peaks, and is one reason supporting my assessment that real GNP will not decline significantly further.

(2) In addition to the cyclical decline in aggregate activity, recent economic conditions have been affected significantly by an ongoing structural shift in the mix of economic output. Since mid-1986, when retail sales and consumption peaked as a percent of GNP coincident with the peak in the real trade deficit, exports have been rising sharply as a share of national output, while shares of

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retail sales and consumption, residential investment, and government purchases have been receding (See Chart 3). While monetary policy influences aggregate economic trends, changes in relative prices and economic incentives created by the sharp decline in the U.S. dollar beginning in 1985, the Tax Reform Act of 1986, and the dramatic decline of oil prices in 1986, have generated the following shifts:

- Exports have risen from 10.8% of GNP in 1986 to 14.9% in 1990; thus, exports have outgrown real GNP by approximately $170 billion.
- Retail sales and consumption have grown slower than average economic output and have declined as shares of real GNP. The declining share of nondurable goods consumption--a decline of 1.8% of real GNP, or approximately $75 billion in real terms--has severely plagued department store sales. Consumption of durable goods, including automobiles and household appliances, has slumped.
- Consumption of services has continued to rise as a share of output, but recently that trend has begun to flatten.
- Residential investment has declined sharply in real terms, and its share of GNP has eroded below 1980 levels.
- Government purchases are falling relative to GNP, reflecting the slowdown in federal defense spending and state and local capital expenditures.

(3) **The shifting mix of output is having a marked impact on economic performance by industry and by region of the nation, and it is contributing to the unique profile of this economic correction.** During typical recessions, manufacturing industries on average underperform and undergo major restructuring as they attempt to eliminate inventories and adjust production and costs to lower levels of product

demand, while the service-producing industries generally outperform. In contrast, traditional manufacturing industries are faring better during this economic correction. Continued healthy growth in exports raises the demand for U.S. manufactured products. Moreover, most manufacturing industries already lowered their production costs during major restructuring programs in the 1980s, and inventories are generally low. On the other hand, several of the service-producing industries that usually outperform during recession--the financial services and retail trade industries--are underperforming and undergoing jarring restructuring.

Real estate prices and activity tend to be very sensitive to economic cycles, and this correction is no exception. The key differences in this cyclical episode are that the excesses in real estate that evolved in the 1980s were unusually large in certain regions, and the adjustments to the recent shifts in the economic, tax, and demographic fundamentals that fueled the real estate boom were not properly anticipated, particularly by the banking industry.

The economies of the eastern seaboard, which experienced some of the largest excesses and have heavy reliance on employment and output in industries that are declining, and parts of the west coast that rely heavily on defense industries, are underperforming the national average. In contrast, the midwestern and northwestern states are outperforming, reflecting their heavier reliance on export-oriented manufacturing and agriculture. This is a reversal of the relative regional performances prior to 1986, when the real estate, consumption and the financial industries outperformed, while exports and the agricultural belt were slumping and manufacturing was undergoing a painful restructuring.

I believe that some observers calling for a sharp recession may be unduly influenced by the sharp declines in real estate prices, the problems in the banking industry, or the underperformance of their local economy, particularly if they reside on the east coast or certain areas on the west coast.

(4) Even though real GNP continued to grow in 1989-1990 (albeit at a decelerating rate), recessionary-type conditions unfolded that normally occur when real GNP is declining. In addition to the slowdown in nominal GNP growth,

- Corporate operating profits declined significantly--over 6% annualized in 1989-1990 (See Chart 4).
- Nominal and real interest rates, particularly short rates, fell significantly.
- Real estate prices and activity declined.
- Inventory building slowed, and businesses took major steps to cut operating costs.
- Credit quality deteriorated significantly, and business failures and bank problems rose.

Each one of these trends was fully in place before the August 1990 oil price shock and the mideast crisis. The spike in oil prices lowered real disposable income and jarred consumer and business confidence, and contributed to the deteriorating economic conditions, but did not initiate them.

These economic trends in 1989-1990 suggest that many of the excesses that typically unwind during recession already have been adjusting. If nominal product demand growth stabilizes, which I anticipate based on my assessment of domestic demand and export growth, the worst economic news has already occurred. Certainly, the corrections and adjustments to date have been severe and jarring, and they are incomplete in industries that are underperforming and restructuring. *In light of the complex profile of this correction, the debate about whether the recession will be "mild" or "severe" based solely on the magnitude of the decline in real GNP is oversimplified.*

(5) **I anticipate real GNP to be relatively flat in the first half of 1991, rather than continue its sharp decline of the fourth quarter 1990, and then rebound slowly in the second half of 1991.** This would imply that the level of real GNP get back to its third quarter 1990 level by Fall 1991. The economy will continue to expand in 1992. If the Federal Reserve aggressively eases monetary policy, economic growth in the near-term would be faster, but excessive stimulus would reintroduce capacity bottlenecks, interrupt the disinflationary process, and jeopardize sustained economic expansion.

This relative short-run optimism stems from my assessment that product demand and nominal GNP growth will not fall significantly further, and because businesses have been adjusting their production and operating costs to the slower product demand growth. I believe the largest declines in employment have already occurred, and that consumption will stabilize following its sharp fourth quarter 1990 decline. Recent statistics indicate that economic activity began to stabilize in December following sharp declines in October-November. Employment will continue to recede modestly through mid-year, with a larger portion of the job losses occurring in the service-producing industries. The unemployment rate should rise from present levels, but not rise significantly above 7 percent. Business investment in inventories and producer's durable equipment will remain subdued in response to weak corporate cash flow and sluggish product demand. Government purchases may rise, reflecting the costs of the U.S. involvement in the mideast. Exports are projected to continue to rise modestly, but slower than their recent pace.

Historically, powerful rebounds from recession have been characterized by a sharp acceleration of product demand generated by aggressive monetary easing. If the Federal Reserve continues to allow the federal funds rate to recede gradually, merely reflecting subsiding demand pressures associated with the weak economy, without

significantly pumping up bank reserves or money growth, then the economic rebound will be slower than typical rebound, but healthier for long-run economic prospects.

Even if real GNP rises modestly from its fourth-quarter 1990 or first quarter 1991 trough, recessionary-type conditions will persist, and the recent trend in the mix of national output will continue to plague real estate, financial services and the retail trade industries, and the east coast in general.

(6) Economic performance in 1991 hinges as much if not more on continued healthy growth of exports than it does on domestic consumption, which tends to vary little during recession. The conventional view is that because consumption constitutes nearly two-thirds of GNP, consumer behavior is the key swing factor determining economic performance in 1991. I disagree. During past recessions, the vast majority of the decline in real GNP from peak to trough was attributable to declines in business investment in inventories and producer's durable equipment, and to declines in real estate, while consumption played a relatively passive role. Although consumption dropped sharply in fourth quarter 1990 as the mideast crisis and oil price shock lowered real disposable income and jarred consumer confidence, it is expected to stabilize and rise modestly in 1991.

Exports grew approximately 6 percent in 1990, while domestic demand slumped. Based on the expected lagged response to the lower U.S. dollar in 1989-1990, and continued growth overseas, U.S. exports should grow slightly less than 5 percent in 1991. Persistently restrictive monetary policy and the higher taxes imposed by the Ominbus Budget Reconciliation Act of 1990 will restrain domestic demand, so continued growth in exports is imperative. Recently, foreign demand for capital goods and industrial materials have been strong, particularly in Europe. Thus, continued economic expansion and growth of capital spending, particularly in Germany, France and the rest of Europe, are crucial to U.S. economic performance.

(7) The problems of the banking industry, tight lending standards, and declining bank loans are more a reflection of the deteriorating economic conditions, credit demand and credit quality than a constraint on total credit supply, and therefore are not as much a cause of the present economic slump as a symptom, and will not constrain future economic expansion. The primary sources of bank loan demand during the 1980s expansion were business capital spending, financing for inventory building, highly leveraged transactions including leveraged buy outs, and real estate development. Since late 1988, each of these sources of loan demand dissipated, and the economic fundamentals have changed significantly. Banks failed to properly anticipate these fundamental changes and how they would alter the banking environment in terms of loan demand and credit quality. Reflecting the changing industrial mix of economic output, the most severe problems emerged on the eastern seaboard. Many banks were significantly overweighted in assets of declining industries and activities (i.e., real estate, LBOs, etc.), and consequently suffered major losses. In general, the largest impact of the tighter enforcement and scrutiny imposed by the Office of the Controller of the Currency (OCC) was to force banks to realize losses already incurred and to more prudently apply existing credit standards under realistic economic assumptions, than to establish new credit standards.

As domestic bank lending has declined, credit supply from non-bank sources such as commercial paper, private placements, non-depository institutions including credit companies, and foreign sources, has increased. This shift in the sources of credit has reduced domestic banks' market share and hurt selected firms, particularly small firms in weak industries, but its impact on the aggregate economy has been overstated.

The problems facing banking are not just cyclical, but structural in nature: as the growth of private debt slows, there are too many depository institutions and an

excess of human resources in the financial services industry. Consequently, bank failures, consolidation and job losses in financial services will continue, regardless of economic conditions.

There is also substantial concern that a severe recession may result from an implosion of the significant debt buildup in the 1980s. While the financial viability of selected businesses has been jarred by slumping revenue growth and huge debt servicing requirements, business bankruptcies have not spread in a domino fashion that would cause sharp declines in aggregate economic output. Neither will they, unless there is a further significant deceleration in product demand, which would prevent corporate cash flows from keeping up with debt financing needs, causing layoffs and driving up household defaults. But this is not expected. The Fed has been allowing the funds rate to decline, which will prevent further decline in domestic demand, and exports should continue to rise. Consequently, severe economic distress and financial default should not spread.

(8) **Although any war scenario economic forecast is highly uncertain, a short armed conflict in the mideast is unlikely to have a sharp depressing impact on real GNP, particularly if oil supplies are not materially disrupted, as many oil experts assert.** If oil prices were to rise sharply, disposable personal income for non-petroleum consumption in the U.S. and other industrialized nations would be reduced. This would extend the fourth quarter 1990 decline in consumption, and slow U.S. exports, as worldwide economic growth, particularly in Europe, would suffer. Defense outlays would push up government purchases, partially offsetting the decline in private output. However, many oil experts say worldwide petroleum supplies should not be materially disrupted in the event of war and, if so, oil prices should not surge dramatically unless panic buying is widespread. Moreover, oil price increases may be temporary and limited by (a) the current large supplies of available oil; (b) the

slowdown in worldwide demand for petroleum, and (c) the release of strategic petroleum reserves by the U.S. and Japan.

Forecasting the net adverse economic impact of a temporary war is highly speculative. Estimating the impact of any conflict on the economy should be based primarily on the affect of *real* variables on business and household behavior; less concrete influences, such as the psychological impact on consumer confidence, while important, are usually temporary, and tend to be overestimated. While my assessment that the net negative impact on real GNP would not be dramatic carries a high degree of uncertainty, any projections provided by large macroeconomic models carry the same caveat.

(9) **Core inflation will decline gradually but significantly in 1991-1992, and interest rates will ratchet down from present levels, reflecting below-average economic growth and falling inflationary expectations.** A classical disinflationary process, initiated by tight monetary policy that has generated the marked slowdown in nominal and real GNP growth since 1988, is just beginning to produce declines in core inflation. Monetary policy affects inflation with a substantial lag. To many, the Fed-induced deterioration in economic performance appears to be a costly exercise that is not pushing down inflation. In fact, core inflation has risen modestly since 1987. However, like previous disinflationary episodes, the short-run impact of the slowdown in nominal demand growth has been to reduce real growth and profits. The next stage in the disinflationary process is lower core inflation as businesses and households adjust to the slower nominal product demand growth.

The oil price shock temporarily boosted the general price level and generated sharp increases in the CPI and PPI, but due to monetary restrictiveness and the economic slowdown, the shock is not becoming permanently imbedded in other prices.

Oil price declines are beginning to generate temporary monthly declines in the CPI and PPI.

My outlook for inflation is more optimistic than projections by the government or the Blue Chip Concensus forecasts. I expect inflation to fall below 4 percent in 1991 and to approximately 3 percent by year-end 1992. *This will create a very strong base for economic expansion in the 1990s.*

Interest rates, which in the long run reflect economic and inflation fundamentals, should continue to recede in 1991. Short-term rates declined in 1989-1990 primarily in response to deteriorating economic conditions. Long-term rates did not recede in 1990, and the yield curve steepened in response to a variety of factors, including higher foreign interest rates, concerns about inflation, the federal budget, and the mideast crisis. Any permanent resolution of the mideast crisis would lead to an immediate fall in long-term interest rates and a flatter yield curve. Moreover, the longer the Fed maintains its long-run disinflationary policy, flatter will be the yield curve and the more long-term rates will eventually recede.

(10) The budget accord of October 1990 was a significant step forward in terms of reducing current services deficit projections, but the actual deficit is rising. The budget process lacks credibility and the budget debate continues to steer away from the vast federal transfer programs, so the subdued financial market response to the legislation was not surprising.

The budget accord slashed the current services deficit projections for fiscal years 1991-1995 by nearly $500 billion, a significant accomplishment given the highly charged political environment. Yet the following shortcomings are also apparent:

- The new deficit projections for FY1991-1992 provided in October 1990 were dramatically higher than the official government projections provided just two months earlier, and the revised Gramm-Rudman-

Hollings deficit targets again had been grossly violated. Present official deficit projections presumably are significantly higher.

- The majority of the deficit cuts were "backloaded" into FY1994-1995, and relied heavily on the seemingly inconsistent projections of above-average economic growth (driven primarily by productivity gains) *and* declining real interest rates, an unlikely combination.
- The majority of the legislated deficit cuts were achieved through higher taxes and Medicare premiums, while a minority involved spending cuts, and social security and the retirement programs were barely touched.
- The budget accord reinforced the recent trends of allocating a declining share of federal resources for investment activity, including education, research and development, and infrastructure, and a rising share of nondiscretionary entitlement spending for nonmeans-tested programs.
- The Budget Enforcement Act of 1990, the third revision of the original GRH, effectively closes some loopholes and should provide better control over certain categories of federal spending. *However, like its predecessors, the new law excludes from the sequestration process social security and most other nonmeans-tested entitlement programs, which are at the core of the deficit problem, and sorely in need of restructuring.*

The vast majority of the balloon in the projected deficits in FY1991-1992 is attributable to weak economic conditions, the costs of Desert Shield, and the additional working capital for the Resolution Trust Corporation's (RTC) savings and loan restructuring activities. Outlays for the RTC are basically a realization of prior government obligations, and represent money already spent. Excluding them and adding the social security surplus, the deficit-to-GNP ratio will rise significantly, but remain well below the peak levels of 1983-1986. As the additional working capital

requirements for the RTC recede, the budget deficit should decline in absolute terms and as a percent of GNP, although not nearly as fast a OMB projected in October 1990.

(11) Despite the shortcomings of the Budget Enforcement Act, Congress should make sure it is implemented and not vote to suspend the sequestration process if given the chance. A prudent fiscal policy must be followed, and any attempts to stimulate the economy through higher discretionary spending should be rejected. For example, any legislated increases in unemployment insurance must be offset by cuts in other discretionary spending programs. The new legislation allows the deficit targets to adjust for short-run changes in economic conditions, but also limits outlays in the discretionary categories to changes in inflation estimates. This new flexibility adjusts the budget deficit for economic cycles and correctly focuses attention on reducing the structural budget deficit.

A forecast of two consecutive quarters of declining real GNP by the CBO would require the Senate to vote to maintain or suspend GRH's sequestration process. With the new flexibility in the target calculations, a vote to suspend would represent a lack of fiscal responsibility, and would be met by a severe loss of credibility.

Budget policymakers must keep fiscal policy on a prudent course and not increase discretionary spending in an attempt to counter the cyclical downturn in the economy. There is vast uncertainty about the short-run fiscal impact of a change in fiscal policy. Economists disagree about the magnitude, timing, and even the direction of the fiscal policy multipliers. In contrast, there is general agreement that persistently high budget deficits will eventually impinge on private sector investments and long-run economic growth, although the timing and the magnitude of the impact is uncertain. These difficulties suggest that a prudent course of budget policy requires avoiding the use of fiscal policy as a short-run demand management tool.

(12) Fiscal policy is vastly more complex than just the size of the deficit: policymakers should refocus the fiscal debate on the tax and spending structures underlying the deficit, the economic and financial responses to them, and the broader implications of budget policy for the allocation of national resources. Lower deficits are desired, but the way in which they are reduced is crucially important to the mix of economic output and long-run economic growth. A rising share of federal spending goes for transfer payments and social security, while a declining share is allocated to investment-oriented activities. Moreover, the vast majority of all entitlement programs are not means-tested, and certain entitlement programs are flawed structurally and have unintended distribution consequences.

Deficit spending for consumption-oriented activity effectively redistributes wealth from future generations to the current one, and lowers long-run potential growth. Given the magnitude of federal dollars allocated to the non means-tested entitlement programs, and the opportunity costs of those resources, effectively excluding them from the budget debate places a severe constraint on the budget process and reduces its effectiveness.

Changing worldwide financial trends, with slower growth in saving and a reallocation of the stock of worldwide savings to Germany and eastern Europe, raises further concerns about the potential adverse impact of these domestic fiscal trends. Higher taxes should not be confused with fiscal responsibility. They do not alter the mix of spending. Moreover, higher taxes may not raise national saving if they reduce expected rates of return and dampen private saving and investment.

While these fiscal issues are difficult, my simple observation is that the near single-minded focus on the deficit in recent years has diverted attention from some very basic issues.

(13) Monetary policy and fiscal policy are not substitutable, and efforts to adjust either in an attempt to achieve a desired fiscal-monetary policy mix are misguided and should be avoided. As the budget accord was being debated in Fall 1990, the Federal Reserve held out the carrot of lower interest rates in response to significant deficit cutting, and the CBO's baseline forecast projected that a large deficit cut would *strengthen* economic activity, because it would be accompanied by an easing of monetary policy. Whether or not this influenced the fiscal debate, the "policy mix" framework is alluring but potentially dangerous.

Attempts to adjust monetary policy in response to fiscal actions in order to achieve a desired fiscal-monetary policy mix are misguided because they assume incorrectly that monetary policy and fiscal policy are substitutes for achieving the objectives of long-run economic growth and stable prices. Such substitutability requires that a shift in fiscal policy is capable of generating a permanent shift in aggregate demand, while a shift toward monetary stimulus is capable of raising long-run output. Instead, excessively stimulative monetary policy generates inflation, but does not raise long-run potential output. Fiscal policy alters the allocation of national resources between the public and private sectors and influences long-run potential output by altering incentives to consume, save and invest, but does not generate a permanent shift in aggregate demand. Moreover, even the attempt to change the policy mix to achieve a desired short-run economic objectives requires that the magnitude and timing of the economic impacts of fiscal and monetary policies are understood; they are not.

Interestingly, while statistical releases revealed deteriorating economic conditions as the budget debate was conducted in Fall 1990, the Fed pegged the federal funds rate and effectively tightened monetary policy by draining bank reserves, and then lowered the funds rate modestly after the budget accord was enacted. Ironically, while the appropriate response of monetary policy to the change in fiscal policy should

have been *neutral*, the lengthy budget debate may have delayed Fed action and inadvertently contributed to tighter monetary policy.

(14) I encourage the Federal Reserve to maintain its long-run disinflationary monetary policy, avoiding an overly aggressive monetary easing, but to loosen its operating procedure of rigidly targeting the federal funds rate, and to immediately take steps to bring money growth closer to the midpoints of it's target ranges. This would involve lower short-term interest rates.

Low inflation is a necessary ingredient to maximizing long-run economic growth and job creation; moderate inflation was a key factor that contributed to the longevity of the 1980's expansion. In response to inflation the Fed began tightening policy in 1987, substantially earlier than it had in previous cycles, and has successfully constrained some of the excesses that have characterized previous bouts with inflation. Importantly, although the Fed has allowed the federal funds rate to decline 3 percentage points since April 1989, those declines were largely in response to subsiding demand pressures associated with deteriorating conditions, and did not involve any monetary stimulus. Since 1987, bank reserves have been virtually unchanged (up until the reduction in reserve requirements in December 1990) and real (inflation-adjusted) money balances have been flat. Consequently, the lower short-term interest rates have been consistent with the Fed's long-run disinflationary goal. Since September 1990 nominal money balances have been flat, resulting in substantially negative growth in real money balances.

The Fed is encouraged to conduct a monetary policy consistent with declining long-run inflation, but avoid an overly restrictive policy that would generate further declines in economic activity. A monetary-induced sharp acceleration in domestic demand would lift the economy, but would halt the disinflationary process. On the other hand, a persistent decline in money balances would damage the economy. *The*

Fed's operating procedures of rigidly targeting the federal funds rateincreases the difficulty of successfully walking this policy tightrope, and raises the probability of a policy mistake.

The funds rate is a policy lever of the Fed, but it also *reflects* credit demand pressures associated with economic conditions. Conducting monetary policy in an attempt to influence the path of nominal economic activity by rigidly targeting a variable that is significantly affected by the economy is prone to policy mistakes. Pegging the funds rate either too high or too low may involve a deceleration or acceleration in money and credit growth that is inconsistent with desired aggregate demand growth. This is particularly true when economic performance is shifting; Fed efforts to fine-tune the federal funds rate often results in monetary policy procyclically following economic performance. In Spring 1989, for example, the Fed pegged the funds rate at 9.8 percent as economic growth was decelerating, and this involved the sharpest year-over-year decline in bank reserves since 1960. The associated decline in real money balances contributed significantly to the slumping economic performance in late 1989 and 1990. More recently, since September 1990, money balances have declined, despite the significant decline in the funds rate. This decline is clearly undesirable.

I encourage the Federal Reserve to:

- Loosen its policy of rigidly targeting the federal funds rate and, instead, pay more attention to bank reserves and its money and credit growth targets. This change in procedure would eliminate some of the undesired wide fluctuations in liquidity that in the past have generated erratic trends in domestic demand growth.
- Immediately take the necessary steps to bring money growth closer to the mid-points of the Fed's target ranges for M2 and M3.

Under current economic and financial conditions, these directives would involve further gradual declines in interest rates, but would not be inconsistent with long-run declines in inflation.

CHART 1

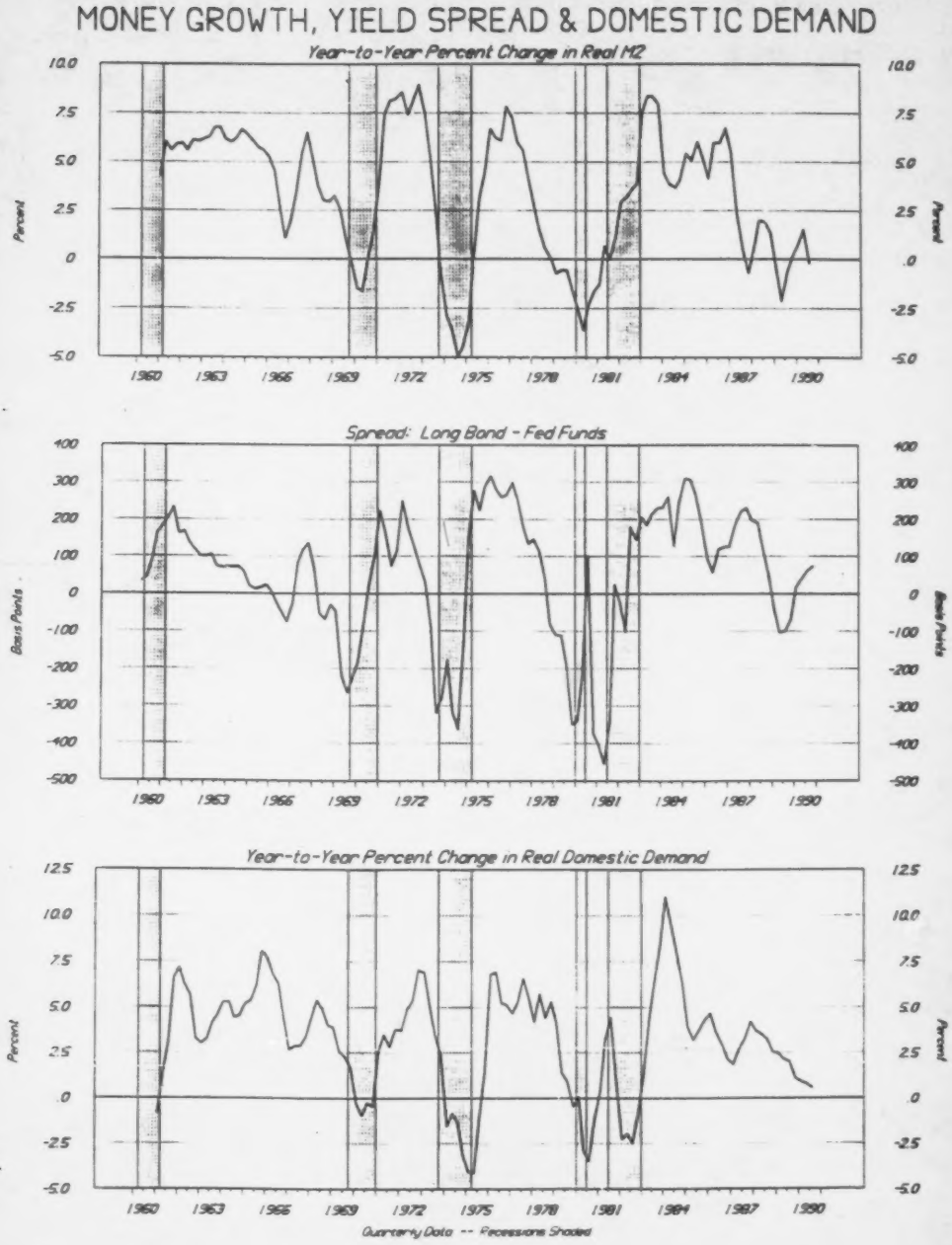

MONEY GROWTH, YIELD SPREAD & DOMESTIC DEMAND
Year-to-Year Percent Change in Real M2
Percent
10.0
7.5
5.0
2.5
0
-2.5
-5.0
1960
1963
1966
1969
1972
1975
1978
1981
1984
1987
1990
Spread: Long Bond - Fed Funds
Basis Points
400
300
200
100
0
-100
-200
-300
-400
-500
Year-to-Year Percent Change in Real Domestic Demand
12.5
10.0
7.5
5.0
2.5
0
-2.5
-5.0
Quarterly Data -- Recessions Shaded

CHART 2

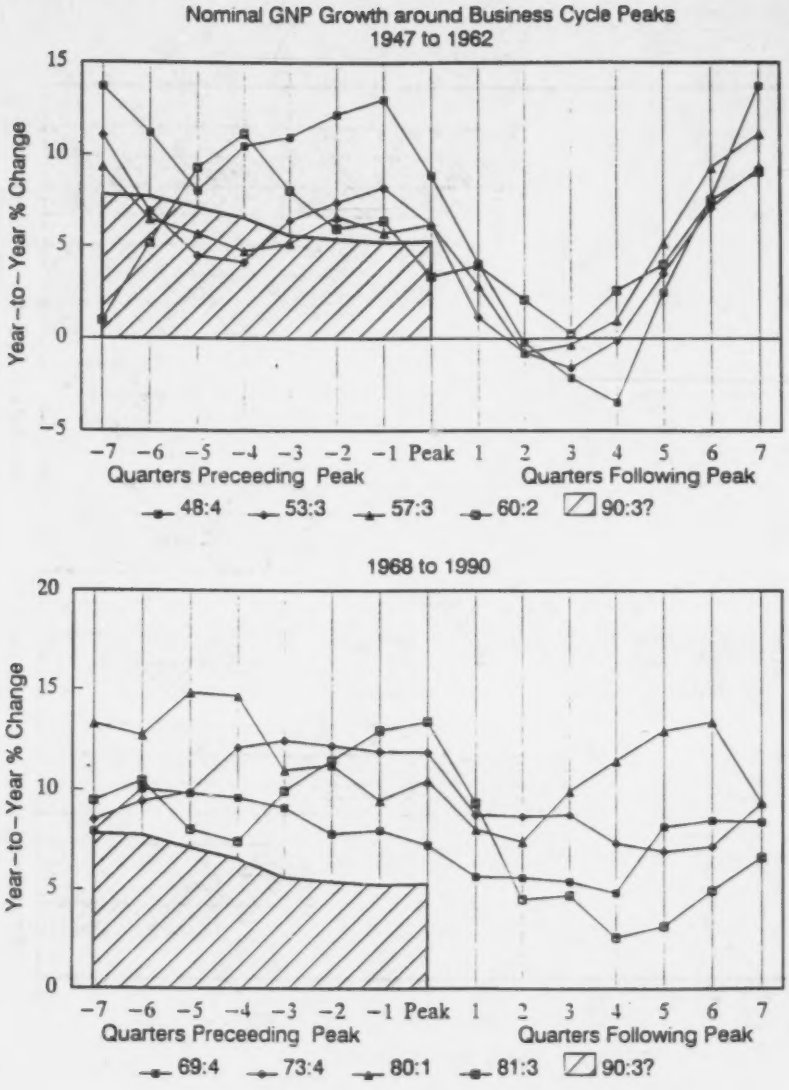

Nominal GNP Growth around Business Cycle Peaks
1947 to 1962
Year-to-Year % Change
15
10
5
0
-5
-7 -6 -5 -4 -3 -2 -1 Peak 1 2 3 4 5 6 7
Quarters Preceeding Peak
Quarters Following Peak
48:4
53:3
57:3
60:2
90:3?
1968 to 1990
Year-to-Year % Change
20
15
10
5
0
-7 -6 -5 -4 -3 -2 -1 Peak 1 2 3 4 5 6 7
Quarters Preceeding Peak
Quarters Following Peak
69:4
73:4
80:1
81:3
90:3?

CHART 3

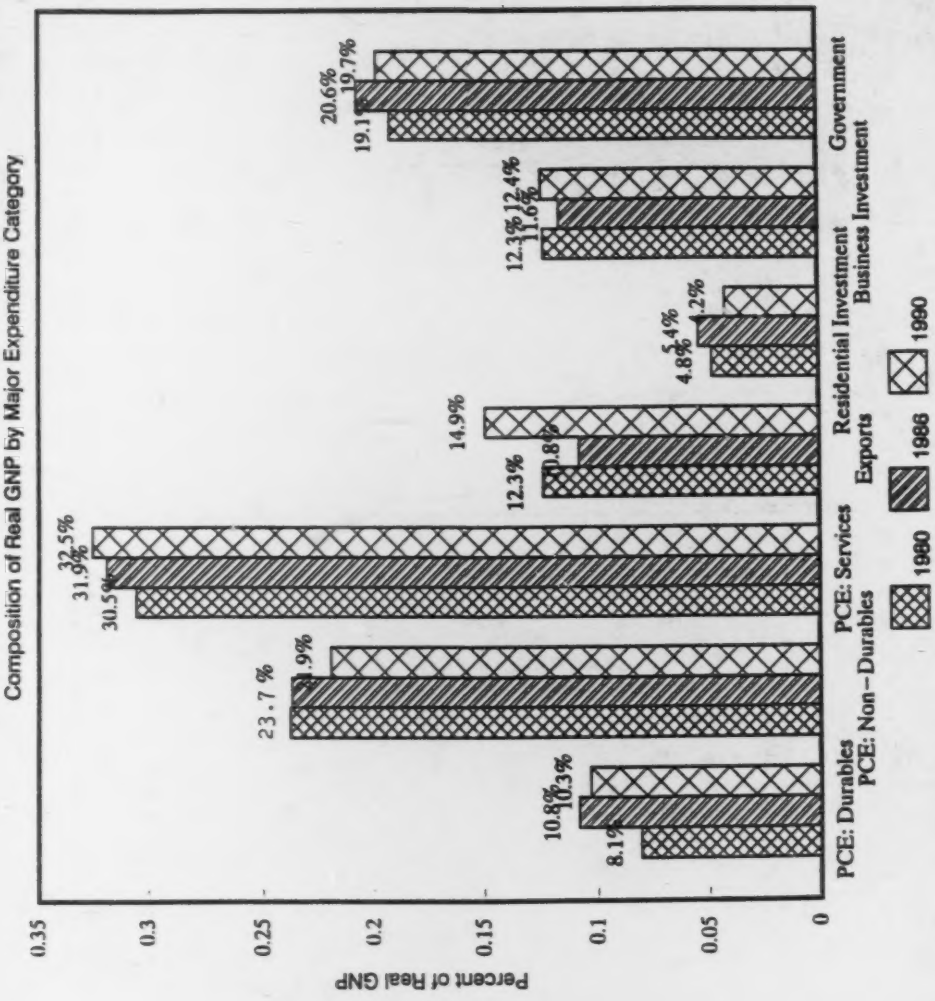
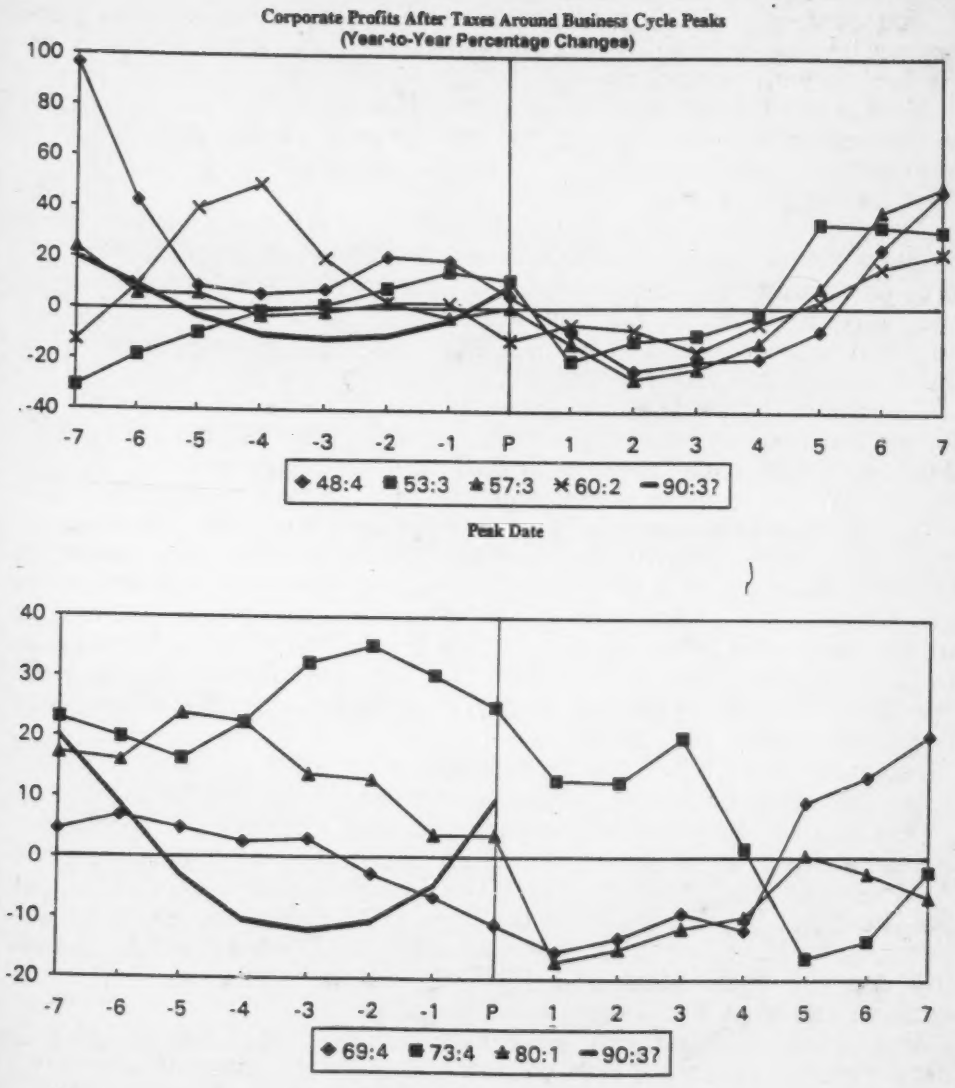

Composition of Real GNP by Major Expenditure Category
Percent of Real GNP
0.35
0.3
0.25
0.2
0.15
0.1
0.05
0
32.5%
31.9%
30.5%
23.7 %
14.9%
12.3%
10.8%
10.3%
8.1%
20.6%
19.7%
12.3%
12.4%
11.6%
5.4%
4.8%
4.2%
PCE: Durables
PCE: Non-Durables
PCE: Services
Exports
Residential Investment
Business Investment
Government
1980
1986
1990

CHART 4


Corporate Profits After Taxes Around Business Cycle Peaks
(Year-to-Year Percentage Changes)
100
80
60
40
20
0
-20
-40
-7 -6 -5 -4 -3 -2 -1 P 1 2 3 4 5 6 7
48:4 53:3 57:3 60:2 90:3?
Peak Date
40
30
20
10
0
-10
-20
-7 -6 -5 -4 -3 -2 -1 P 1 2 3 4 5 6 7
69:4 73:4 80:1 90:3?

Chairman SASSER. I will turn to Senator Exon now for his questions.

Senator EXON. Thank you, Mr. Chairman.

Let me start with you, Mr. Friedman. You said that we did nothing in 1985, or 1987 and so forth and so on. But you think we have done something with the summit meeting in 1990. How does your confidence level, how realistic is that when you compare that with 1985, when we did do something—Gramm-Rudman? It didn't work very well, but we did something.

You evidently didn't have much confidence, either at that time or you have developed a lack of confidence in Gramm-Rudman according to your testimony.

How is the budget summit in 1990 differ from the promises made in Gramm-Rudman?Senator, but at the end of the day, I fear I sympathize with what I take to be the thrust behind your line of questioning more than I wish I did.

First, on the one significant difference: As I see it, there have been two major strands of the legislative effort to restrict the Federal Government within the past 10 years. The one that we implemented with Gramm-Rudman-Hollings focused on the deficit per se. That seemed like a good idea, but it proved ineffective as Senator Hollings, himself, pointed out earlier.

An innovation in the new agreement is to focus not on the deficit alone, but also on spending—with spending caps, and more specifically, spending caps for three specific kinds of spending.

I would like to believe that this two-gun approach might be more effective than the previous one-gun approach. Nevertheless, as I explained in some detail in my written remarks, sir, to this innocent outside observer, the agreement that the President and the Congress reached in October seems as if it were intentionally designed to be revisited in the spring of 1993. By my calculation, the great bulk of the realistic, rather than the paper, reduction in the deficit—that is to say, the real bite of the spending caps—comes only beginning in the 1994 fiscal year.

Senator EXON. After the presidential election?

Mr. FRIEDMAN. Yes, sir, exactly so. And, therefore, as I went on to explain in my prepared remarks, to me it looks as if the agreement is designed to be revisited in the spring of 1993, after the next presidential election, when the Congress takes up the budget for the fiscal year 1994. If, at that time, Congress, agrees on specific category spending caps that will fit within the aggregate spending cap for fiscal 1994 and 1995, then I do think we will have achieved at least some significant progress.

But if we don't—if you gentlemen don't—then I am afraid this most recent agreement will be just one more example of promising that the real reductions will come later on when then they never do.

Senator EXON. All right. I have great concerns we will never get the genie back in the bottle, but I guess we should keep trying regardless of how elusive that genie seems to be.

Let me ask each of you a question that I asked the Chairman of the CBO but did not get a very satisfactory answer. Let me see if I can phrase it. Maybe I'm not making myself clear.

I have listened with a great deal of interest to his testimony and your testimony today, all three of you. They are all very well done and a lot of thought has gone into those presentations and I appreciate that.

When you were preparing for this testimony, or over the past 6 months, have you considered the possibility that this might not be just another down-turn? That maybe this is the beginning of a rather serious recession that might last a long time, because we have not, obviously, licked our evils that have undermined what was once a pretty sound economic structure in the United States of America?

Or, to put it another way, have you discounted or put any thought and consideration into the possibility that maybe we are going through an economic readjustment this time that, indeed, is going to lead to a lower standard of living in the United States? Complicated question but can you just give me a short answer?

Mr. FRIEDMAN. The short answer I would give, Senator, is that with perhaps 80 percent probability, or with luck, 90 percent probability, yes this will be an average, ordinary recession that we can calibrate within reasonable accuracy by looking at the eight previous recessions that have occurred since World War II.

But as I emphasized in my prepared remarks, I see perhaps a 10, or even a 20 percent probability that something will crack in the nation's financial system as a result of the financial fragility which has been built up over the past half-decade through excessive borrowing in quantitative terms, and poor borrowing in qualitative terms, that will deprive the financial system of its ability to function in an orderly way.

If that were to happen and if there were any slip whatsoever in the Federal Government's immediate intervention, then the economic down-turn that we are now experiencing would not look like the previous eight that we have had since World War II, and would look quite different in ways that are almost impossible to predict, simply because there has been so little regularity in financial crises in the past. Each one has been different. Each one has had some idiosyncratic cause which has led to a unique set of circumstances. In the event that that happens, then I would not expect the previous post-war recessions to provide a good guide to what will happen this time.

Senator EXON. Thank you.

I would just simply point out that it seems to me that our previous recessions, although they were—a recession is a recession is a recession—we started from a less advantageous position than we do on this one.

Mr. Chairman, I don't want to over-do my remarks. I intend to be here for the rest of it. If it is the Chairman's will I will just—I do want the other two to respond to this—but I will be glad to wait for my second round if that is the interest of the Chairman and the other members. I don't wish to——

Chairman SASSER. That might be the way to approach it.

Thank you, Senator Exon.

Senator Wirth?

Senator WIRTH. Thank you, Mr. Chairman, and thank you very much, gentlemen, for being here today.

We have heard in the past some very, very disturbing numbers on the contribution of our allies to Desert Shield and then Desert Sword. Admiral Crowe, not one to use a lot of hyperbole, used the word "disgraceful" in describing this. This was in November, and it becomes even clearer today.

The January 2nd report showed that cash contributions have been less than $5 billion—our cost is absolutely enormous compared to that—the Japanese have paid a total of $600 million. This from a country with enormous stakes in the gulf conflict. You are familiar with these figures.

If you were sitting where the Congress sits now—other than all the rhetoric, what specifically can we do to force or to compel or to embrace or whatever the verb might be, the Germans and the Japanese and the others to pay more?

What can we do to get the Kuwaitis and particularly the Saudis—whose country after all we are presumably over there defending, and they have provided a pitifully small amount of money—what can we do to get them to contribute more?

Mr. BERGSTEN. Senator, I think the first question is what you count in terms of their contribution. Let me focus on the Saudis, and what we hope will be a restored government of Kuwait. Ask yourself what they could do most effectively to help our economic future.

My answer may surprise you. It is not direct contributions to our budget, although I think they ought to contribute a big chunk of that, indeed more than they have. The best thing they could do to help us is make sure that the price drops and stays down for the indefinite future.

Saudi Arabia is the swing producer in the world oil market and therefore essentially determines the world energy price structure. The Saudis have responded very rapidly to the crisis by increasing production, and thereby holding prices down—and prices indeed have come back down, despite all these daily fluctuations, to a level where I think, once hostilities end, we'll see oil prices at or below where they were before the crisis broke out. And that is the best prospect, actually, for a short-term recovery in the economy.

So what we really want from the Saudis, to be very precise, is to continue to pump 8.5 million barrels a day, despite the fact that from a profit maximization standpoint, when the war is over and the war premium disappears from that market, they might prefer to produce less in order to keep the price from collapsing.

That is just one example. But the payoff to our economy from that variable swamps anything that is possible at the budget level. Ten dollars a barrel on the oil price is worth $60 billion a year of GNP to our economy, even before you take into account multiplier effects.

So you first have to ask yourself what counts.

I mentioned in my statement that we want to see continued rapid economic growth in Japan and Germany—led by domestic demand, not exports—to permit us to achieve export-led growth. That, it seems to me, is part of "burdensharing" and ought to be a big element in the equation.

I am fully with you on more budget contributions. I'd say take the budget cost and divide it up in thirds: we'll pay one-third our-

selves, the Gulf Arabs pay one-third, and the other industrial countries pay one-third.

Senator WIRTH. How do we get that to happen? What tools do we have, if any——

Mr. BERGSTEN. That's the problem.

Senator WIRTH [continuing]. What tools do we have to say to the Saudis keep the price of oil down? If this war is over in a relatively short period of time, there is going to be enormous pressure on the Saudis, I would think, from the other Arab countries to maximize the amount of income coming in and redistribute that in order to keep the lid on all of the extraordinary pressures for social and economic change in the Gulf area.

Mr. BERGSTEN. But let me amend the way you phrase the question. What can we do to get them to cooperate that does not shoot ourselves in the foot? For the future we could say, "Well, if you don't pay up, we won't defend you next time." But that's not in our interest.

We could say to the Japanese and Germans, "We'll restrict trade with you," and that is a possible course. But as you know that's not always beneficial to our own economy.

We could say," We'll drive down the exchange rate of the dollar so now we'll really be competitive with you. But for the reasons I mentioned before, that, depending upon how it is done and how far it went, might have some adverse effects on our own economy.

It is not easy to construct policy steps that will hurt or threaten the other guy without hurting yourself.

Senator WIRTH. I would disagree with one-third/one-third/one-third. I would say it would be one-half and one-half with the U.S. at zero. I mean, we've got $288 billion and 500,000 young Americans over there; that's a pretty significant investment by itself. I think the other costs ought to be one-half and one-half.

Mr. BERGSTEN. That's part of what you count. The British, for example, are making a military contribution, and maybe that's enough for them, but from the Germans we want something different.

Mr. LEVY. Senator, the burden of distribution of the costs of public sector spending should approximate the distribution of the benefits, whether you are spending for roadways or bridges or consumption-oriented activity. So we have to ask who benefits from the U.S. involvement.

If the war benefits only current U.S. citizens, then raising taxes would be appropriate. However, I believe that the war effort contributes to national security for future generations, so borrowing is appropriate. The war also benefits tremendously other industrialized nations.

And I would like to point out that the U.N. Security Council voted unanimously to support the United States. At least nations in the Security Council should pay commensurate with the benefits they gather.

Senator WIRTH. But how do you get it to happen? I agree with that. We had that wonderful resolution, sort of, "We'll hold your coat, Uncle Sam, while you go and fight." Now how do we get to the point of saying that allowing them to hold our coat is not enough? What is the cost going to be to them?

How do we get that to happen?

Mr. BERGSTEN. To come back to what I said before, we've got three big levers in international economic negotiations. One is the security blanket that we provide to other countries, whether it is the European allies or Japan or the Gulf Arabs. We can take a hard line and say, "You've got to pay for your defense." I think for the longer run, in a post-cold war world, where you've got to allocate between military and economic responsibilities, that needs to be done. But we have to note that that could undermine our objectives. That's one lever.

The second is access to our market——

Senator WIRTH. OK. Now, can we really use that as leverage? Why don't we? Should we do that?

Mr. BERGSTEN. In certain selected, carefully orchestrated ways and as part of a long-term strategy, I think we can and in some sense do. When the Congress mandated the administration to go out under section 301 of the 1988 Trade Act, that was using leverage to some extent. We said, "Unless you open up to us on A, B, and C, we'll close to you on X, Y, and Z." I actually think that policy has been quite successful so far.

Senator WIRTH. For every barrel of oil that the Japanese import from the Persian Gulf there will be a $100 tariff on American automobiles, or on automobiles exported to the United States—is that the kind of thing you're thinking about?

Mr. BERGSTEN. As I said, you'd have to define what counted, and you'd have to make sure you didn't shoot yourself in the foot.

Senator WIRTH. What would you do? What is the leverage? What leverage do we have, say, on the Japanese?

Mr. BERGSTEN. Well, autos are one case in point. Their industry is competitive with our own, and particularly in a period of unused domestic capacity like we have now, automobile access to our market could be used as leverage. I suspect, although there would be some adverse cost to our own economy from restricting those imports, that we could get a very quick and favorable Japanese answer.

Senator WIRTH. Would that be a good thing to do? Is that a good policy to pursue?

Mr. BERGSTEN. It's a very tough call because of the adverse effects——

Senator WIRTH. I mean, the cost of the war to our economy is enormous. We just heard $30-$80 billion—Sam Nunn says $90 billion—that is an enormous cost to the economy. You're telling us that if we had the Saudis keep the price of oil down, that could save us $60 billion; that gets us two-thirds of the way toward what Sam Nunn says the cost is going to be——

Chairman SASSER. Sixty billion of GNP, not $60 billion in money that comes from——

Senator WIRTH. I understand. OK, I understand we're mixing a little bit of apple and orange. But still, what do we do? The Japanese came into my office—I'm sure they came into your office, Mr. Chairman—and very proudly said, "We're going to commit $2 billion"—this was a long time ago— of which we have seen a grand total, I think, of $600 million.

What do we do about this? They are glibly over there, saying they are going to commit all this money and they haven't done anything. Maybe they know something we don't know, and they don't think we ought to be there or whatever.

Mr. LEVY. Mr. Senator, I would not close our markets to trading partners. Typically it is the Nation that closes its markets that incurs the economic loss. Consequently, imposing barriers to trade would raise the cost to the U.S. in a more indirect way.

Senator WIRTH. So therefore?

Mr. LEVY. Therefore I think that is not a good form of leverage.

Senator WIRTH. So what would you do, Mr. Levy?

Mr. LEVY. All I would say is for starters, you go back to the U.N. Security Council and say, "You voted unanimously with us"——

Senator WIRTH. OK, Zaire, ante up. I mean, it's the Japanese and the Germans—these are people who have enormously powerful economies, who are sitting there while we are playing brother's keeper to them—presumably, if this is a wise venture to be there they would be, too.

Mr. LEVY. I understand what you're saying, but we do have to worry about shooting ourselves in the foot. And you can shoot yourselves in the foot economically as well as diplomatically, and that is my caution.

Senator WIRTH. Mr. Friedman—I'm sorry, Mr. Chairman; I know my time has expired, but can I hear from Mr. Friedman?

Chairman SASSER. Yes.

Mr. FRIEDMAN. I don't pretend to have a specific answer for you, Senator, so I'll give you a more general answer than you're probably looking for.

There is a big difference between being the leaders of the 21st century and being the Hessians of the 21st century. We have to do, at a level that's a lot deeper than this tit for that tat, is figure out what it is that we're trying to lead. That means that we have to have some kind of vision of the world order that we want to be at the head of. Simply being at the head without knowing what we're the head of doesn't do anybody any good.

Once we have accomplished that, no doubt there will be responsibilities that we will expect the Japanese and the Germans and the Gulf Arabs to play in the world order that will transcend mere bilateral United States-Japanese relations. To me, frankly, it isn't very important what our bilateral relationship is with the Japanese; triangular trade has been an important part of the American economy for at least 200 years. What matters is whether, in the overall scope of things, the Japanese are living up to their responsibilities. But as far as I can see, nobody has defined what that set of responsibilities is.

The sense of frustration that you articulate is one that we all share, but I suspect that going at it in a piecemeal way—saying that we have to do something with the Japanese on this issue, we have to do something with the Germans on that specific issue—is never going to get us very far until we have some overarching notion of what we are trying to accomplish in broader terms, and then ask how these countries' individual responsibilities are supposed to fit into that.

If you now ask me how all that translates into what we do tomorrow, I'll just be honest and say I don't know.

Senator WIRTH. That's the frustration, I appreciate, and that's what we had the debate about was what are our long-term goals, and it was an extraordinarily good debate and not altogether clear what our specific goals are and where we are going, but anyway there was a vote, and we agreed to go to war, and that's where we are right now, and the question is who is paying for it. I think the American public is as frustrated and maybe more frustrated than you and me, and I find it extraordinary that it appears to me the President spends more time giving photo opportunities to President Assad or bringing the Chinese out of the cold after Tiananmen Square than he has really pushing others to contribute to this effort in a very, very severe effort, a very strong effort.

I think we've got to do everything we can to push him on that. I know the chairman has done that. I think we have a big job ahead of us.

Thank you, Mr. Chairman. I'm sorry to take so much time. I appreciate it.

Senator EXON. May I add just a note, for a little bit of levity here, Mr. Chairman. Maybe one of the answers to your question would be to declare war against Saudi Arabia, Germany and Japan and carry on what was suggested by a previous witness, that war is a good investment. That would really solve things, wouldn't it?

Chairman SASSER. Well, it occurred to me that we have 400,000 troops in a country that's got 30 percent of the world's oil supply.

The question that I'd like to ask you, Dr. Friedman, and then perhaps get Dr. Bergsten to respond also, is that we hear from the Congressional Budget Office and then from you gentlemen this morning that this is going to be a relatively typical, post-World War II recession. Dr. Bergsten didn't say that precisely. But it appears to me that our tools for dealing with this recession are very limited. We have heard testimony here this morning that our hands are tied with regard to fiscal policy because of our failure to address the problem—of our large deficits in the decade of the 1980's, so we don't have that tool available to us.

On the question of monetary policy there is some question here about whether or not reducing interest rates will really do the job because we've got the question of whether if you reduce rates on the monetary side, what happens on the credit policy side, that the lenders are still not going to be eager to lend the money because of past problems. And then, simultaneously, we have this problem—if we are going to reduce rates—of trying to continue to attract that $10 billion in foreign capital per month to finance the deficit. If we bring those rates down much lower, then it appears to me we're going to have great difficulty in attracting that capital.

If you superimpose on that the enormous amount of consumer and corporate debt, the fact that real estate markets are deeply troubled and that deep deflation in real estate prices is possible in a number of areas around this country, then you have the financial fragility of the financial structure in this country.

Dr. Friedman, why aren't you predicting more than a 10–20 percent chance of this recession being one that could be deeper and more dangerous than we had in the typical recession at the end of

World War II? It appears to me 10–20 percent is a minimal chance considering all of the factors that I see out there that are adverse.

Mr. FRIEDMAN. You may be right, Senator. I hope you are not, but you may be. To me, however, even a four to one shot that something like a banking crisis may occur is large enough; that is itself cause for serious alarm.

But let me also address the set of policy tools that you mentioned, sir. First of all, on fiscal policy, it isn't that we can't use fiscal policy; it's just that it would be unwise to do so at this time. I agree that we should not use fiscal policy for this purpose.

Second, however, on monetary policy, I do not believe that monetary policy has been sufficiently aggressive in resisting the current downturn. Monetary policy was eased only in a delayed fashion, and even then stintingly. The Federal Reserve has fallen behind the momentum of the downturn and is now playing catch-up and especially with the current fragility of the banking system, that is not a comfortable position for any central bank to be in. I believe that there is much more that monetary policy can do.

As I also explained, however, we have a problem in the banking system which is not just a monetary policy problem. Some forbearance on the part of the bank regulators at this time would therefore be not just appropriate but also necessary in order to allow the lowering of interest rates by monetary policy to have its effect.

Finally, what about the dollar? I certainly agree with Fred Bergsten that having a dollar crisis is not in anybody's interest. But I suspect that there is plenty of room for the dollar to come down. If we now lower our short-term interest rates and, the same does not happen in financial markets abroad, the dollar will probably come down. As long as that does not happen in a precipitous way, I don't see anything wrong with the dollar coming down; indeed, I would welcome that.

At the end of the day, though, Senator, we just have to face the fact that because of our excesses of the past decade—and within these, I include policy errors in our fiscal policy and also the excesses of the private financial markets—we are not as well-equipped to combat a recession as we have been at most points in our post-World War II history. The recession is therefore likely to be more severe than it otherwise would have been, had we been able to respond in the way in which we have in the past. This is simply part of the price we have to pay, both for the private excesses and for the governmental policy mistakes of the last decade.

There is a quality in the American psyche, which I think proves helpful over the long run, that assumes that everything always has to prove workable, that there always has to be a way out, and that no matter how badly we have gone astray, we will always be able to make it right. But the fact that we will now sustain a larger downturn in economic activity, with more widespread unemployment and more loss of incomes, and a heightened risk of some type of disruption in the banking system, is not something that we can magically wish away; this is part of the set of facts on the ground created by the way in which both the government and the private markets have run their affairs during the past 10 years.

Chairman SASSER. Dr. Bergsten, what is the probability that some kind of explosion would occur here that would be very dam-

aging economically, damaging to the economy? You alluded to that I think in your prepared testimony.

Mr. BERGSTEN. Right. I would place the risk of a very severe financial disruption somewhat higher than Professor Friedman. I wouldn't go up to 50 percent, but I'd say it is higher than his 10 to 20 percent because I do place a greater weight on the external risks, the drying up or even the withdrawal of the foreign money that is here now—what is sometimes called the "hard landing" for the economy. That was a concept that some of my colleagues and I developed at our Institute about 5 years ago.

We got a close brush with it back in 1987, when there was a withdrawal of foreign funds, and the foreign central banks had to step in and finance basically the whole of our external deficit that year. I'm not sure they'd do that now because of the change in their economic circumstances. So I would give it a higher risk.

The other part of my answer to you and to Senator Exon is that, yes, this one could be very different from previous recessions. The danger is not so much that we'll get a 1930's-type depression in terms of an enormous decline in the economy, but that the slowdown may be much more prolonged than that 11-month average that Bob Reischauer mentioned, and that the likelihood of a catch-up recovery is much lower.

My image, as I tried to lay out in my statement, is one of slugflation as far as the eye can see. I think there is a risk—call it one-in-four—of a very sharp decline. But I think there is a high probability—and this is really in answer to Senator Exon—that the profile of this period will turn out to be quite different from the post-war average in terms of both its duration and the absence of a sharp recovery.

We have already had 2 years of a very sluggish economy; growth has now turned negative for two or three quarters, and it is going to continue pretty sluggish because I don't see the engines of recovery available that we have had in the past. Lean inventories reduce the chance of a sharp fall but don't give me much confidence that we'll have a sharp rebound.

We have debated a bit how efficacious monetary policy can be. I continue to doubt either the likelihood or the desirability of a sharp decline in interest rates. I agree with Professor Friedman that a modestly lower dollar, achieved in a very orderly, nondisruptive way, is a good thing. I said that in my written remarks. But the risk of a precipitous, sharp, disruptive fall of the dollar would, I think, be quite high if we went to an aggressive lowering of interest rates.

And even if we did, and even if the regulators forbore, I'm not sure the banks are going to pump out a lot of money anyway, given their quite understandable and legitimate concern to strengthen their balance sheets, their reserve positions, and the like. Even if the regulators got off their backs next week, the banks know that the stock market analysts aren't going to get off their backs, that the depositors aren't going to get off their backs, and so they are going to have to refurbish their fundamental structural positions.

So I have a lot of sympathy for Senator Exon's implied view on this. Indeed, I laid that out in my own remarks. But I want to make a distinction: it is not that I'm suggesting we're going to have

a deep depression like the 1930's, although I think there is a slightly bigger risk of that than Professor Friedman says. Instead I see slugflation. And that I think is wholly unsatisfactory, but it may be that that is the price we pay, as Professor Friedman just said, for the profligacies of the 1980's. We let our house get out of order. Professor Friedman didn't use the title of his recent book, but it might be appropriate here: the day of reckoning may be here, and we may just have to slog it out for a number of years before the underlying structural situation, both in terms of government finances and in terms of the private sector, is back in adequate shape to give us policy tools, give us flexibility, give us a financial order that can sustain a strong economy, and we may therefore have a half-decade of that kind of performance before we can get back on a desirable track.

Chairman SASSER. Dr. Levy, do you wish to respond to that?

Mr. Levy. Yes; people are using the word "fragility" in the financial system. I don't care whether the economy grows for 3 percent over the next 5 years; the banking industry is going to continue to restructure.

We have far too many banks, far too much capacity, and there is going to be a continued shakeout. I do not think the shakeout will interrupt the facilitation of commerce.

Let me give you an example. GMAC now has over $100 billion in financial assets. That is as large as a thousand of average-sized banks. There has been a dramatic change in the sources of credit. Banks have been losing market share for a long time, and not just to foreign banks. Credit through private placements, nonfinancial commercial paper, and credit corporations such as GMACs and Westinghouse Credit has increased sharply. Credit from these nonbank sources is cheaper than credit from banks.

So when we talk about the financial industry, it is no longer just banks, and we cannot just look at how a certain bank is crumbling and say, oh no, we're really in trouble. There has been a structural shift that will continue regardless of economic performance.

Chairman SASSER. Well, let me just stop you there and ask you this, Dr. Levy. How about GMAC and how about Ford Credit Corporation? We hear reports that in order to keep their volume up, they are loaning money on automobiles to the point where the consumer gets to a point where he owes more on the automobile than it is worth, and we are getting record defaults and record repossessions.

Now, does that add to the fragility of the financial structure?

Senator EXON. Are you suggesting, Mr. Chairman, that the consumer is pretty well overburdened now, not only with his car payments, but his credit card payments?

Chairman SASSER. I'd say that's correct, yes.

Mr. LEVY. Delinquency rates have not skyrocketed to the point where they could be extremely troublesome in the aggregate.

Now, when you assign probabilities to whether you could have a debt implosion-led recession or "financial explosion" or whatever, I think one has to consider under what situation would that occur. Such a situation may occur if the Federal Reserve, by targeting the funds rate too high, continues to drain liquidity out of the system, generating a sustained decline in nominal GNP. Under these condi-

tions, businesses' product demand and revenues would fall short of expectations, impinging on their ability to repay their debt. This would lead to contraction and further layoffs.

Therefore, it is incumbent upon the Federal Reserve to focus on liquidity. The issue of Fed easing should not focus on interest rates, which reflect economic conditions, but instead money growth, as measured by the various aggregates. But up until December 1990, we have had zero growth in bank reserves for 3 years and no growth in inflation-adjusted money.

With regard to people's perceptions about the economy, it is all too easy to take the last 2 or 3 months of data and what you read in the papers, and just extrapolate linearly. Usually, that extrapolation proves to be incorrect.

I note that Federal Reserve Chairman Greenspan in testimony yesterday said he is paying more attention to the money numbers, and he wouldn't have done that 2 years ago. I might note that in mid-1989 I was asked to testify as part of the Humphrey-Hawkins testimony. And I took one look at the decline in real money balances to date, the fact that money was growing slower than inflation, and the fact that the yield curve was sharply inverted; and forecast better than 50 percent chance of recession by the end of 1990. It seemed at the time to be a logical result of the squeeze on liquidity. But the Federal Reserve didn't see that, and it kept on pegging the funds rate too high.

A common question is: How low do interest rates have to go to reinvigorate the economy? My answer is I don't know, because interest rates reflect what is going on as well as being a policy lever, and that is why I think the Fed should focus on money growth.

Even if the Fed starts pumping in liquidity, will banks make loans? I would say yes, eventually, to the extent that that increase in liquidity increases product demand. But the focus should not be on banks exclusively. When the Fed lowers the funds rate, it reduces the marginal cost of funds to credit corporations more than it does for the average large bank because of banks' poorer credit ratings. And so you want to look at all sources of credit and the total aggregate amount of credit.

Chairman SASSER. Thank you. I have one more question, gentlemen, and then I will defer to you.

I would like to look back for just a moment at what some have called the good times of the 1980's, and many of our colleagues talk about—and we hear it discussed at great length in other places—the fact that this is the longest peacetime recovery in the history of the economy, the clear implication being we are a lot better off as a result of the policies of the 1980's.

I would like to look back at the 1980's for just a moment and ask you, Dr. Friedman, when we clear away all the dust, I wonder how good the 1980's really were. Are most Americans better off today than they were after the last recession in 1982?

Mr. FRIEDMAN. Mr. Chairman, the average working American is earning less today than he or she earned in 1983. In that year, which was the first year of the current economic expansion, the average American working in private business earned $281 a week. Today that is not $281 or $280 or $270 but down in the $260's some-

where, after adjusting for inflation. On average, people are losing ground.

There is a very dangerous pair of trends in the country now. That is this mix of a declining average income with widening inequality. At many points in the past, we have had one or the other, but in each case there has always been the favorable one to use as a way of rationalizing the other. When inequalities have widened sharply, people have argued that this is the temporary price we pay for economic progress. Conversely, when incomes have been stagnating on the average, at least we haven't been losing ground on the inequality front. If the average income were rising today, for example, the discussion of the inequality issue would be very different. We would hear a lot about how a rising tide doesn't exactly lift all the boats; some are left behind, and the society must deal with them.

If we do not turn around this combination, it could prove very volatile. The popular press has taken the view that one of our two political parties is ideally postured to take advantage of this combination of declining average income and widening inequality. I think that is dead wrong. The kinds of frustrations and angers and anxieties and tensions that are generated by this particular combination are too volatile for us to be confident that any part of the convention political structure can readily harness it. My naive guess is that if this combination persists, we will see those frustrations and anxieties and tensions popping out in all sorts of ways that are external to our two major parties. And if historical experience is any guide, some of it isn't going to be very pretty.

Some people have done well in the 1980's. Most people haven't. The average has gone down. That combination is one that doesn't bode well for the well-being of the Republic.

Mr. BERGSTEN. Could I add one statistic that relates to your question? During that steady growth period of the 1980's, the United States borrowed $800 billion net from the rest of the world. The rest of the world basically financed our entire expansion. Without that borrowing, interest rates would have been sky high and you wouldn't have had the recovery.

We shifted during that period from being the largest creditor country in the world, which we were as late as 1983, to being the world's largest debtor country, and the debt is rising rapidly. That is just one indicator of how it happened, and the implications are obvious about some of the long-term costs that will arise from its having happened.

Mr. LEVY. Two points. One, with regard to the 1980s, my perspective is the 1980's will go down historically as the decade of the internationalization of the goods and capital markets. Real wages fell in part because they rose too rapidly in the 1970s relative to productivity growth. So the internationalization of the goods market caused an adjustment in real wages. So I don't think 1980 is a good benchmark because we were out of whack in 1980.

Chairman SASSER. I thought you said that the problem is that wages were growing in the decade of the 1970's faster than productivity. So wouldn't that mean that 1970 was out of whack, the decade of the 1970's?

Mr. LEVY. No; 1970 I think was much more in line. I am saying the correction of the 1980's in terms of declining real wages despite rapid productivity growth in our manufacturing industries was an adjustment.

My second point is to relate what Professor Friedman said regarding the distribution of income to budgets. In my testimony is stated that we should pay more attention to the mix of Federal spending. Is it appropriate that less than 20 percent of all of our entitlement program spending goes for means-tested programs, while the vast majority goes for non-means-tested programs? Specifically, social security and a lot of the non-means-tested programs are excluded from the Gramm-Rudman-Hollings sequestration process.

Regarding Dr. Bergsten's comments about the Federal rising debt, what are we borrowing for? My biggest concern is we are borrowing for consumption-oriented activity. At the same time, included in the three discretionary categories that are under the new pay-as-you-go system, are spending programs for education, and infrastructure and research and development. Outlays for these programs declining as a share of total spending.

In terms of a desirable pro-growth mix of spending, the current Gramm-Rudman-Hollings process reinforces the wrong spending priorities. The pay-as-you-go requirement should be applied to consumption-oriented transfer payments, like social security and the non-means-tested programs, while those programs that are investment-oriented should not be pay-as-you-go. Borrowing to spend more for investment that increases the Nation's long-run productivity is desirable.

Chairman SASSER. I think you are quite correct, Dr. Levy, but to play the devil's advocate, it could be argued that social security not only pays as you go but is developing a very substantial surplus. That is the political argument that you would get if you tried to put a portion of it on pay-as-you-go.

Mr. LEVY. Although when we think of Social Security, we must consider the current surplus with respect to the long-run liabilities which are very large.

Chairman SASSER. That is correct. But nobody seems to be thinking about the long-run liabilities.

Mr. LEVY. Yes; I am very sensitive to the political arena in which you have to conduct yourself, but I would say the current budget process imposes constraints, not just on reducing the magnitude of the deficit, but on the mix. I think that is very important.

Chairman SASSER. Let me say to my colleagues here that our distinguished witnesses have suffered through 3½ hours of being in this room, and I think at some point we ought to give them some respite and show some mercy here. Do we have another round of questions here?

Senator EXON. Yes; very briefly.

Gentlemen, thank you for your patience. Your testimony has been very interesting and very informative.

Mr. Levy, I am not sure you had a chance to respond to my earlier question that has been commented on. If you have said what you want to say on it, fine. To summarize my question, has the economic community done, in your opinion, enough study of whether or

not this is a cyclical recession, or given the difficulties we have now, does it portend a possible significant readjustment of the world economies to the adverse effects of America in the longer term?

Mr. LEVY. Mr. Senator, I think in general the economics community is riveted just on GNP and doesn't look at the structural shifts in the mix of output. In fact, in my written testimony, I focused on those shifts of how certain industries and regions are underperforming.

With regard to a probability of something really going wrong, I think you want to consider under what circumstances would nominal GNP growth plummet. If it stays at 5 percent by the Federal Reserve lowering interest rates and adding liquidity, then the economy will continue to undergo structural shifts, and the banking industry will continue to decline but, on average, the economy will not unravel.

On the other hand, if for some reason—exports collapsing or the Fed remaining too tight too long—that nominal GNP falls, then we are in trouble. I don't see that happening. I was very encouraged by Dr. Greenspan's remarks yesterday that he is focusing more on money. Presumably, if he is focusing on it, he will do something about it.

Senator EXON. Thank you, Mr. Levy. I guess the only thing I have about that is, once again, I think focusing on money and interest rates may be a traditionally short-sighted way of looking at this rather than the long term.

But let me move on to another question that I think is a follow-up on this. The Washington Post—I believe it was yesterday—had a story about foreign investment and how foreign investment, if it is true, was waning in the United States. But at the same time, the Post reported that acquisition of American companies had actually increased in 1990 over 1989. The rather interesting thing connected therewith is that foreign companies, rather than bringing money in, are now using the credit markets in the United States with which to purchase American companies.

It seems to me that you could make a pretty good case that it is just great for these foreigners to come in here and lend us money through T-bills to finance our deficit. But maybe they aren't doing that any more. And if the Washington Post article is anywhere near accurate, if the foreign entities are in here using our credit markets to buy out our assets—"our" being American—does that not bring a new problem with regard to scarcity of capital that would be available in the United States?

Mr. BERGSTEN. Two points right at the start on the statistics. First of all, the net capital inflow to the United States did remain at the level of about $100 billion last year. We ran a current account deficit of $100 billion, that has to be financed by an inflow of foreign capital, and so we know that money came in.

What we do not know is where it came from last year. In the first half of the year, in fact, the recorded flow of capital was slightly negative—a slight outflow from the country. The current account deficit was financed, in the technical jargon of the balance of payments accounts, by what are called errors and omissions. We know the money came in, but we don't know from where or for

what purposes, whether it was T-bills or CD's or direct investment, which you referred to.

We do know that the composition of the foreign capital inflow over the last year, or a little before, has become much shorter term in nature. That is partly what you were saying.

My view has been that if we are going to get ourselves hooked on foreign capital—as we have—that direct investment, where foreigners come in and put up new plants or even buy real estate, is more stable because the foreign investors are not going to take that out the next day. When they put it in here in short-term form, it can go back out as fast or faster than it came in and create the crash of the dollar and the hard landing I talked about.

So the shift in financing that was the subject of that article that you referred to adds to this fragility that we are all talking about. It is nothing new for direct investors to finance their investments locally. American firms have traditionally done that. Much of the American direct investment in Canada, in Europe, and around the world for the last 30 years, has been financed locally. It basically comes down to a question where it is cheaper to get your money.

With U.S. interest rates, as we said before, having fallen much lower here—last year in particular—than they are abroad, it stands to reason that a Matsushita or a Sony or a Siemens will finance its investments in the United States by borrowing in the United States at lower interest rates. That is a perfectly natural, normal phenomenon.

You can come back, as you did, and say, "But then do we get as much out of the investment?" Again, I think the answer is twofold: first, they are still eventually investing in hard assets such as plant and equipment here, so the money is less likely to go out; second, when they begin to earn money on those investments, they don't just take the dividends and earnings back home. They have to repay the loans they made here in the first place.

So it is a highly circular flow. It is not quite as straightforward as that article indicates. But to me the bottom line is a further indication of our financial fragility, because foreign investors are now much more heavily invested in short-term assets, and that brings us closer to this point of difficulty of a possible withdrawal of foreign funds, which would send the dollar into a sharp decline.

Mr. LEVY. Mr. Senator, it really doesn't matter whether foreigners are using our credit markets or theirs because money is fungible. Whether U.S. or foreign investors borrow from the Euro currency market or borrow from any U.S. bank really doesn't matter because it is all one pool of funds.

I would add two other points. One is that in risk-adjusted terms foreign investors have the same objectives as U.S. investors, and the fact that there was a decline in capital inflows last year just reflected what happened in the U.S. economy. It will come back. I argue strongly that the internationalization of the capital markets increases the stability of the financial system rather than makes it more fragile.

Now, with regard to fragility of the markets, I would point out a trend that concerns me. One of the reasons why the skyrocketing deficits in the early 1980s did not result in earlier anticipated crowding-out impacts is the unprecedented capital inflows afforded

by rapid growth of total worldwide wealth and the total stock of worldwide saving. Those trends have changed. The stock of worldwide saving is either slowing in its rate of growth or declining, depending on how you measure it; and, secondly, there has been a reallocation of the worldwide stock of savings toward Germany and Eastern Europe, where there are higher expected rates of return.

In this changed environment, our current fiscal policy path and our current allocation of national resources toward consumption-oriented activities could possibly create many more problems than it did in the 1980s.

Senator EXON. Gentlemen, thank you very much. You were talking worldwide problems. Representing a very viable rural State, Nebraska, I guess what I am most concerned about is the fact that while it has an indirect effect, the borrowing ability and interest rates, a Nebraska farm operation or a Nebraska small business, whether it is a production facility or whether it is a retailer, might be squeezed out, I would think, somewhere along the line. If the foreigners are, indeed, borrowing more and more money in our credit markets, I am not sure that that bodes well for the small entrepreneur as opposed to General Motors and people like that.

Thank you very much, Mr. Chairman, and thank you, gentlemen, for being here today.

Chairman SASSER. Thank you, Senator Exon.

Do you have a further question or comment, Senator Wirth?

Senator WIRTH. No, I don't.

Chairman SASSER. Gentlemen, I want to thank you very much for appearing here today. I think the importance of your testimony can be judged by the fact that the Senators sat here for almost an hour-and-a-half past their lunch hour to listen to you today. I thank you very much for appearing here. I think you have made a real contribution to our deliberations, and I hope you will come again at a later date.

The committee is adjourned.

[Whereupon, at 1:38 p.m., the committee was adjourned.]

CONSIDERATION OF THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1992

TUESDAY, FEBRUARY 5, 1991

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:06 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Jim Sasser (chairman of the committee) presiding.

Present: Senators Sasser, Hollings, Riegle, Exon, Lautenberg, Simon, Sanford, Wirth, Conrad, Robb, Domenici, Symms, Grassley, Kasten, Nickles, Gramm, Bond, Lott, and Brown.

Staff present: Larry Stein, staff director; John J. Callahan, deputy staff director; and Alan Cohen, assistant director for budget priorities and review.

For the minority: G. William Hoagland, staff director; and Austin Smythe, senior analyst for budget process and energy and natural resources.

OPENING STATEMENT OF CHAIRMAN SASSER

Chairman SASSER. The committee will come to order.

This morning the Senate Budget Committee begins its hearings on the fiscal year 1992 budget. We are pleased this morning to have the Director of the Office of Management and Budget, Mr. Richard Darman, appear before us today, looking rested and relaxed, very self-assured this morning.

Just this past October, we participated with the Administration in the largest deficit reduction agreement in history. This bipartisan agreement reduced current and future budget deficits by $500 billion over 5 years, and it turned us partially away from the borrow-and-spend policies that have produced a $3 trillion increase in the national debt just since 1981. We now are in the unenviable position of the national debt amounting to about 50 percent of the gross national product of the United States.

The bipartisan budget agreement that we enacted into law last year did not—I want to repeat, did not solve our deficit problem. We have before us now—and it will be presented to us today by Mr. Darman—one of the largest budget deficits this country has ever faced, a deficit that is made larger by the twin problems of recession and the cost of the Persian Gulf conflict. The size of this deficit will make it very difficult for us to combat the economic ills of the recession or to face a long list of growing and long-neglected domestic problems and priorities.

The Bush administration has submitted a proposal which adheres to our 5-year budget agreement. I applaud and support the overal fiscal constraints contained in this budget, yet I would be remiss if I did not say that this budget also contains what I perceive to be some very serious flaws.

First, I think the budget before us today pays little heed to the domestic economic emergency that our country is facing. We are now at the beginning of what could be a sharp and deep recession. One million Americans have lost their jobs in the last 7 months alone; a quarter of a million Americans became jobless in January of 1991; 2.3 million people have exhausted their unemployment benefits in 1990. Staffing shortages have left people waiting on the average of 7 to 8 weeks to receive their unemployment benefits. Automobile and housing production is down to levels not seen since the deep recession of 1982, which really amounted, I think most economists would say, to a mini-depression.

The financial system is exceedingly fragile, and even the Federal Reserve Board chairman, Dr. Alan Greenspan, seems to be growing increasingly pessimistic about the chances for a quick economic recovery. Yet as far as I can ascertain, this budget presented to us this morning contains literally no significant economic recovery programs for the American worker.

Second, I think this budget substantially ignores the pressing economic and social needs of the working Americans. Yes, the budget does once again propose a capital gains tax reduction, a measure I thought we had given a decent burial last year. But it is back again this year. It seems a perennial non-starter, but this capital gains tax reduction would provide an estimated tax benefit of $15,400 for every American making over $200,000. Now, this tax break would equal about half of what the average American family earns in 1 year.

At the same time, the budget cuts medicare by some $25 billion. This spending reduction must surely, surely, impair the health and hospital services that are needed by 33 million medicare beneficiaries. Such budget priorities do not reflect the pressing domestic needs of the American people.

Finally, I think this budget must deal more aggressively with the financing of the Persian Gulf conflict by our coalition allies. The budget calls for full funding of the Desert Storm operations. I believe the Secretary of Defense, Mr. Cheney, informed some of us yesterday over at the Pentagon that a supplemental appropriation request will be coming shortly, and I believe that supplemental appropriation request will be quickly approved. Our fighting men and women, of course, will have all the tools they need to complete their mission as quickly and expeditiously as they can in the Persian Gulf. But more than $50 billion has been pledged to offset the costs we have incurred in the Persian Gulf conflict.

Now, of the $50 billion that has been pledged, as of December 31, 1990, a little less than $6 billion has been actually received. This administration must aggressively seek and collect the remaining pledges of assistance and also continue to press for further international assistance as the cost of the Persian Gulf conflict increases. Because of our own serious fiscal difficulties here at home, the United States is reduced to going to other countries around the

world with a tin cup to help pay for these military operations in the Persian Gulf.

But let me end here on a note of optimism, I say to the budget director. Last year the President and the Congress worked together and developed a sound and far-reaching deficit agreement. The Congress clearly will not support a number of the provisions contained in the 1992 budget before us this morning. Nevertheless, we need to continue to find ways to work together within the overall framework of the budget agreement to combat the serious domestic problems that confront our people—serious problems that confront our people due to the recession and, I would submit, due to the decade of long neglect of our persistent economic, fiscal, and social problems.

Having said that, I will now turn to the distinguished ranking member, Senator Domenici, for any statement or observations he might wish to make at this time.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Mr. Chairman, thank you very much. Let me just say, while our committee assignments haven't been made final, I think on our side we know who will be on this committee. With your permission, I would just like to inform the committee that it appears that Senator Rudman has chosen to leave the committee to join the Intelligence Committee.

We have two new members, Senator Brown from Colorado and Senator Trent Lott from Mississippi. The remainder of the committee will be as it was before. I assume, Mr. Chairman, that even though we have not confirmed their membership, in due course they will have their turn, their 5 minutes of questions.

Chairman SASSER. They will indeed, Senator Domenici. I want to take this occasion this morning to welcome Senator Lott and also Senator Brown to the committee. We are very pleased to have both of these very distinguished Senators join us here on the Senate Budget Committee, and I look forward to working closely with them in the weeks and months ahead. Welcome, gentlemen.

Senator DOMENICI. Mr. Chairman, let me just say first for starters that I am very glad that at the end of your opening remarks, you provided a glimpse of optimism. It made me feel wonderful after hearing your eloquent statement of doom and gloom.

We are not here to do everything for everyone. We are here to find out what is in the President's budget. I hope today and in the ensuing days we truly make an effort to find out what is in the President's budget. I believe the Congress of the United States and the President entered into a 5-year budget agreement. While the taxes which were imposed incurred the wrath of a lot of people, many said we had made the right kind of 5-year budget agreement for our people.

Well, what we are going to be busy about is to see how well that agreement works. Because if it produces business as usual, it won't work very well. This budget agreement will not produce business as usual. For those who want to spend a lot more money and figure that we need a lot more programs in this country to solve America's problems, I think they are in for some surprises. Because this

budget agreement, with caps on spending—provides for the first time in a long, long time—maybe in modern fiscal budget history—a new way of doing business. I happen to think it is a much better way, and I happen to think it is a smarter way.

For those who want to solve problems with American programs and expenditures of tax dollars, this agreement says to them no program has immortality. It is saying look at them all and see if they have used up their life cycle. That is what I am beginning to read in this budget. It is saying if you want to do some new things—to spend more money—you have to pay for it.

We should spend more on research and development. We should spend more on early childhood, and we should spend more on national energy policy. You see, I am beginning to say some of the very things the Democrats are saying. Maybe I would do some of them differently. Maybe I would do them the same. But, interestingly enough, saying them I am. And, more interesting, the President proposes a number of new programs. But to pay for them, my friends, he had to go look at existing programs and determine which ones ought to be reduced, eliminated, or changed so we save some money. Frankly, that to me equals deciding priorities, making choices.

Mr. Chairman, we probably can escape making choices in this committee's process, because we can deal in big chunks of money and never make detailed choices here. I urge that the first debate on choices and priorities be in this committee and that we take the choices and priorities to the floor. The President has scaled back or terminated 350 programs. That isn't all. He has asked that we eliminate 3,591 projects. That is all in this budget, and I would like Mr. Darman, as a part of his discussion with us, to tell us how they decided to get rid of projects. Did they pick and choose? Did they decide they didn't like a Senator or Representative? Or do they have a methodology?

But they, indeed, did that so they could spend more money on new programs. They are asking us to turn over $15 billion in program-sharing to the States. And let me say I was very pleased this morning, Mr. Chairman, to see that the last Senator to occupy your chair, Senator Lawton Chiles, was quoted this morning—and I haven't been able to talk to him to see if he is quoted correctly. But he was quoted as saying he favored the President's program-sharing proposal. Maybe it is just because he became a Governor and left the Senate, but it is nice to know that he knows a little bit about what we do and he thinks it is a pretty good idea.

The President is suggesting, too, in this budget, if I read it right, Mr. Darman, that some subsidies go to very wealthy Americans. Although not proposed in any wholesale manner, but to establish the principle and get something started, I understand that the administration has said, well, we ought not be giving subsidies to Americans who earn on an annual basis more than $125,000. He has said let's stop that and put that in some programs for people that have a need. I hope you explain this proposal in detail.

Mr. Darman, on the Medicare Part B proposal for those with $125,000 earnings, I hope you will quickly today separate that for us from your suggestions on the Medicare program at large, which is the biggest part of your cuts and reductions. I think the Ameri-

can people ought to have the difference and have that rather quickly because we tend to put it all together.

In conclusion, the President will increase 250 programs, if I read the budget right, and create a number of new ones. The choices are up to us.

My last comments are twofold: This budget will be growing at 2.6 percent, Senator Gramm, 2.6 percent. Over 5 years, it will grow by a 2 percent average annual rate. It seems to me that we are making some headway. We are moving in the right direction.

Last but not least, for those who were last year on the floor of the Senate and in this committee and elsewhere talking about cutting defense, I heard some say we should have a $250 billion reduction over 5 years. You heard it. Well, the summit compromised, folks, and we have a $180 billion reduction in defense over the next 4 years, including what we did last year. People are now going to find out what that cut does. Those who are informed, such as Senator Exon, you are going to find out all the systems that have to be eliminated and that 500,000 troops have to be reduced, troop strength. That isn't going to be easy, but that is in this budget.

Obviously, defense is coming down dramatically and at the end of this 5-year cycle will be at the lowest level in modern history, 3.6 percent of our gross national product.

I close by saying, Mr. Darman, we should hear from you today—and if not from you, you should tell us from whom—on the issue of the allies paying their fair share of this war. They should. We are led to believe that they are. People are still skeptical. Our chairman appears skeptical whether they will. We should find out what you are doing and how it will come about.

I close with a reminder to our Japanese and German friends. This is not a trade issue. This is an absolute fairness issue. I believe the American people will insist that you pay your fair share, because this is as much for you as it is for us. So I hope when your debates are finished you will see the wisdom of not getting average Americans angry at you because you didn't pay your fair share, because I think angry American consumers are the worst thing possible for the Japanese economy and the Germany economy. And I hope we don't get to that.

Thank you, Mr. Chairman. I look forward to today's hearing and the weeks to come.

Chairman SASSER. Thank you very much, Senator Domenici.

We will now turn to Mr. Darman for his presentation this morning. Mr. Darman?

STATEMENT OF HON. RICHARD G. DARMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. Darman. Thank you very much, Mr. Chairman.

Chairman Sasser, Ranking Republican Senator Domenici, Senator Hollings, Senator Exon, Senator Wirth, Senator Conrad, Senator Symms, Senator Nickles, Senator Kasten, Senator Gramm, Senator Lott, Senator Brown, it is a pleasure to appear before you today to discuss the President's budget for fiscal year 1992. I would respectfully commend to your attention the Director's introduction and overview tables presented with the budget and presented sepa-

rately for you this morning.[1] I believe you each have a copy. I hope you may find it a convenient summary.

With your permission, I would offer a few minutes of introductory comments in addition orally by referring to several charts which are in the introduction and copies of which we have also provided to you independently, and I hope are before you. I will then attempt to respond to all of your questions. If that would be agreeable with you, Mr. Chairman, that would be the way I would prefer to proceed, briefly using these charts, and I would ask to have these charts included in the record.

Chairman Sasser. That is satisfactory.

Mr. Darman. Thank you, Mr. Chairman.

Let me just say, before doing so, that it is a pleasure, as I have said, and I thank you again for the opportunity to return to this committee and will look forward to cooperating with you in the further development of the 1992 budget.

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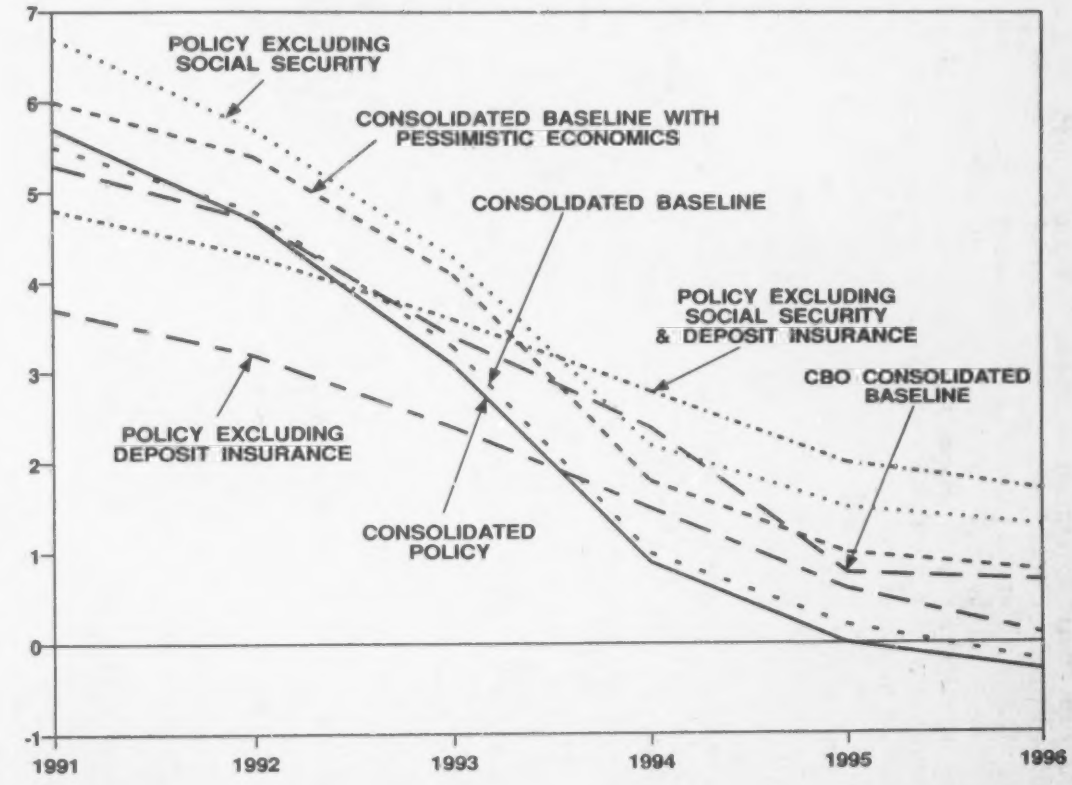
[1] See p. ——.

PERCENT

Chart II-1. DEFICITS AS A PERCENT OF GNP



The first chart is a chart entitled "Deficits as a Percent of Gross National Product," and it is perhaps somewhat confusing in that it has so many different lines on it. The reason it has so many different lines on it is that there are so many different ways people think about the deficit. Some say social security should be included; some say it should be excluded. Some say deposit insurance should be included; some say it should be excluded.

Chairman SASSER. Just a moment, if I might interrupt. Can you see that chart, Senator Conrad?

Senator CONRAD. I have a handout, but thank you for asking.

Mr. DARMAN. He has an exact copy in front of him, I believe, Senator.

Some say the economics should be more pessimistic. Some say you shouldn't trust OMB economics and you should use CBO economics. So what I have tried to do with this one chart is to put many different ways of looking at the deficit on one chart; using more pessimistic economics, using our economics, with social security, without social security, and CBO's estimate. They all suggest the same thing.

If I may, obviously for the period we are in, the deficit looks highly unattractive by everybody's measure. Depending on which way you look at it, it could range between 3½ percent of GNP all the way up to a little better than 6½ percent of GNP. That is the bad news. But by everybody's way of looking at it, it does get better over time, working its way down toward balance and certainly below the deficit levels of our major trading partners by the middle of the 1990's.

Now, since we are not always credible on this—and I understand that—I have included the CBO number here which I will call to your attention. It is this green line here—the dotted one—that is just about in the middle of this pack of lines. That is what CBO is saying.

Now, Senator Hollings I know likes to exclude social security, and there is a large number of people who do that. When you do that, here is the line that you get, and the trend is still the same. It is actually a little bit steeper, a little more favorable in the intermediate years. If you exclude deposit insurance, it looks a little bit the other way. If you take deposit insurance out, it is not so bad in the near term, but it is not quite so good in the long term.

So if you ask, well, why is it favorable for the long term? The answer is that we have in the immediate term two very bad things from a deficit standpoint. One of them is $111 billion in deposit insurance. That gets better over time.

Chairman SASSER. When you say deposit insurance, Mr. Darman, you are talking about the RTC, funding for the RTC?

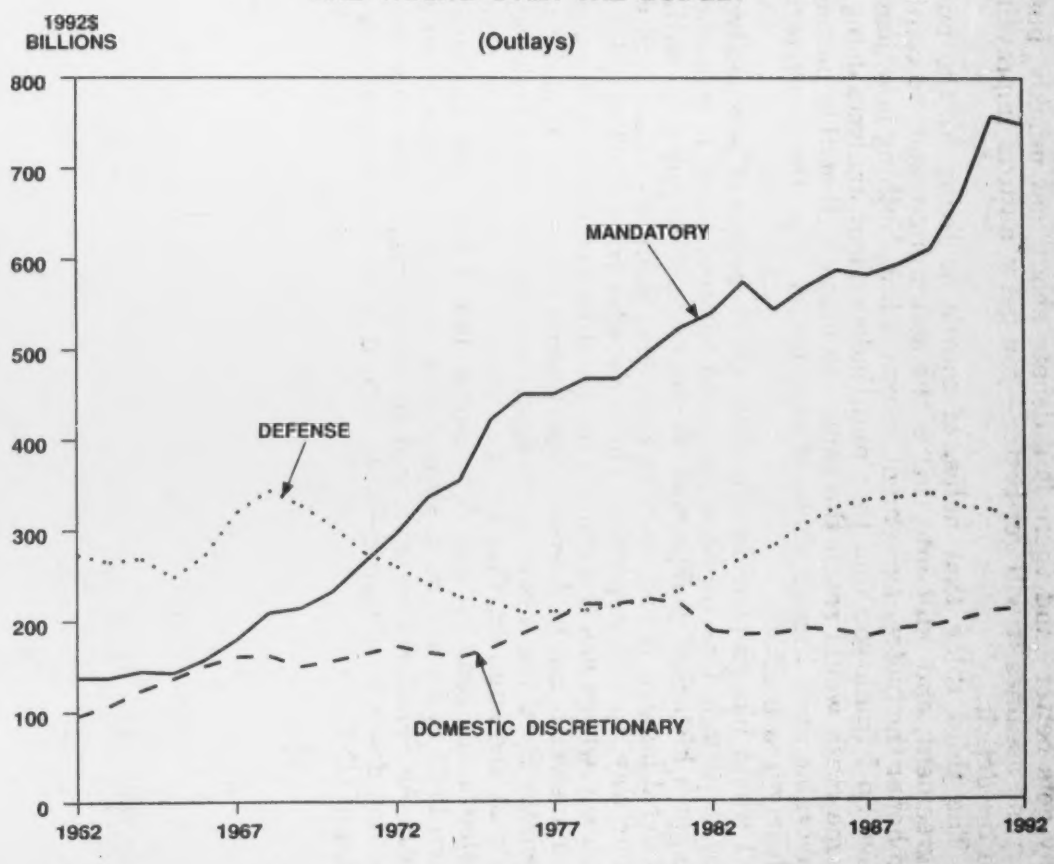
Mr. DARMAN. Yes, Mr. Chairman. I am talking about both the RTC and the bank insurance fund, both the S&L's and the banks. We assume $111 billion of net outlays in fiscal year 1991. Included in the $318 billion deficit which we have for 1991 is $111 billion that is for covering losses and working capital associated with deposit insurance. So for those who would exclude that, you are down here. For those who would include it, you are up here. That is a big element of this.

The second big element is the state of the economy. As the economy gets better—and there is a debate about how quickly, but everyone assumes it will get better—you get a natural improvement in the deficit.

The third thing that helps, of course, is living by the budget agreement, and built into this is the assumption that we continue to honor the budget agreement, which is law. Nothing new, just the law. So I think you find that most independent analysts doing the same math would reach the same conclusions, that this pattern is favorable even though there is no question that the short term is clearly unattractive.

I would like to provide two other quick points of perspective if I could, though. One we have discussed before. I think it is important to get a historical perspective on what has been going on with the Federal budget. If you start at President Kennedy's time and work your way up to the present, three decades from 1962 to 1992, and you say where has the growth in spending been within the budget, the answer is not in domestic discretionary spending. It is the point Senator Byrd has made to us again and again, and I believe, as I said at the summit, that he is correct. It is really not in defense. Defense has gone up and down some, but it has gone up here and then back down and back up and now we are back on a downward path. As Senator Domenici said in his opening comments, we are headed down to a record—well, record of 50 years—low as a percent of GNP.

Chart II-2b. "MANDATORY" PROGRAMS ARE TAKING OVER THE BUDGET



The growth has been—and this chart shows it dramatically—in the mandatory programs. The mandatory programs are, as the chart title says, taking over the budget. They have gone from about a quarter of the budget to 52 percent of the 1992 budget.

Senator SIMON. Do you include the interest in the mandatory?

Mr. DARMAN. No, that is not including interest. If you include interest, the picture is even worse.

I think most of us naturally think of mandatory programs—well, the Congress doesn't have discretion over them but they are for the good. They are somehow going to payments to individuals by and large, which they are, and they must be helping poor people. But if you look at the way in which they have been distributed over time, again from President Kennedy's time to the present, spending on poor people has actually just increased ever so slightly, as you can see on this chart. Whereas, spending within the mandatory category on all other non-poor people just goes right straight up. That is where the money is going.

So to the extent that one thinks 52 percent of the budget is beyond control, but that is a good thing because the money is all going to help address poverty problems, that is a mistaken perception. That is simply not where the money is going.

Senator DOMENICI. Mr. Chairman, could I just ask him to clarify the use of a word?

Chairman SASSER. Yes.

Senator DOMENICI. Mr. Darman, when you use the word "mandatory," most people have been using the word "entitlements," which many Americans have now heard over and over. Could you just tell us, are you talking about some or all of the entitlements when you speak of mandatory or is that different?

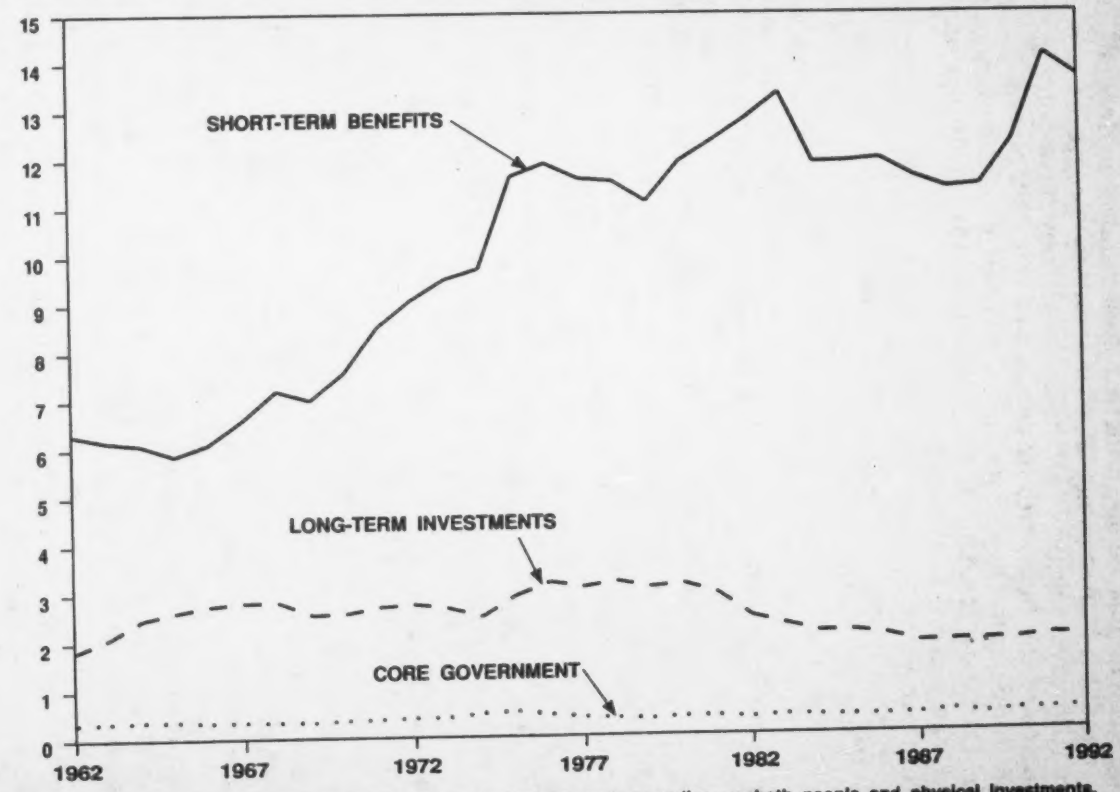
Mr. DARMAN. Senator, as you know, there have been probably three terms,that have been used over time, maybe four. Each is a little bit different, but they overlap.

When I use the term "mandatory," I mean the category of programs as agreed to between OMB and the Congressional Budget Office in our joint classification system. That includes entitlement programs and also some other automatic spending programs that are not subject to annual appropriations. Those are not the largest portion of mandatory spending. For example, when we get to, say, something Senator Hatfield and others don't particularly like, the reform of power marketing administrations or subsidies, that would also be mandatory although not an entitlement. But that is a smaller piece, a much smaller piece.

The two other headings that you sometimes hear are payments to individuals which are the very largest portion of mandatory spending, and what under the new budget act is called "direct spending." Mandatory is the term we have used for the past several years.

Chart II-4. CORE GOVERNMENT, LONG-TERM INVESTMENTS, AND SHORT-TERM BENEFITS

(Total Domestic Discretionary and Mandatory Outlays as a Percent of GNP)



NOTE: Long-term investments and short-term benefits include spending on both people and physical investments.

Let me try to turn to one other point, an introductory point, and then suggest how this is relevant to the way in which we have done the budget. If you lumped all expenditures, apart from defense and interest, together from President Kennedy through the present, where has the money been going, broken down by short-term investment versus long-term? And by short-term, we meant under 5 years. In the longer term, the benefit accrues over 5 years.

If you divide the Government into these three categories, first, core Government functions, the sort of limited government things that the founding fathers might have had in mind extended to the present, this stays roughly constant as a percent of GNP, very small. Long-term investments are also very small. They bounce around a little bit, but they have been coming on down.

Chairman SASSER. How would you define long-term investments?

Mr. DARMAN. Well, I think I can get into an argument on this, and I would be happy to submit for the record, Mr. Chairman, our detailed list of how we classify things. But to give you an example, I would call most R&D long-term investment. Transportation infrastructure would be classified as long-term investment. Generally speaking, capital investments and physical capital would be long-term as would some human capital, where it is demonstrated that there are payoffs, developmentally or other. Some prevention programs, we classified as long-term investment if you could argue that the benefit accrued over an extended period of time. Short-term tends emphasize transfer payments or current consumption activities.

So if you look at where short-term benefits have gone, they have gone, again, more or less straight up. A little interruption, but on the whole, way up. Long-term investments declining, short-term coming up. The reason I mentioned these introductory points, and I appreciate your allowing me to do so, is that they have influenced our thinking about how we should try to restructure and reform within the budget agreement. And as a general matter, we have said mandatory programs have been taking over the budget. If we are serious about the deficit and spending control over time, we cannot leave that 52 percent alone. So, notwithstanding the budget agreement, we have, as has been reported, come back with $47 billion more of proposals in mandatory reforms for additional savings over five years.

We have also said that within mandatory programs, because they have not been efficiently targeted on the poor, we would at least like to start a process that begins the debate and at the margin starts to refocus those programs so that they are more efficient in terms of their targeting on the poor. I will touch on a few of those elements in just a moment.

Then, finally, this particular chart, short-term versus long-term. In a number of the discretionary budget items especially, we have said we want to try to emphasize at the margin a shift of resources for longer-term investment and away from shorter-term consumption. That is the underlying thinking. And again, we are operating at the margin as this next chart will suggest.

DISTRIBUTING BENEFITS MORE FAIRLY

(1) INCOME OVER $125,000 . . .

- Reduce Medicare premium subsidy

(2) INCOME OVER $125,000 . . .

- Reduce farm subsidy

(3) STUDENT AID

- Increase Pell grants for needy

(4) SCHOOL LUNCH

- Greater share to poor/near-poor

(5) VETERANS DEPENDENTS

- Standardize survivors benefits

Within the mandatory program area—entitlements as colloquially called—we tried to start some thinking on the question of better focusing on the poor. And you all have been through this before, and there are many, many different ways to do it, and I won't take too much time. I will simply note what we have proposed.

One, in the medicare area, for people whose incomes are over $125,000, we have said: can't we reduce their premium subsidy? The Federal Government for those people—people I think most people would call wealthy, over $125,000—the Federal Government subsidizes their premiums, as you know, by paying 75 percent of the premium. What we are saying is: can't we reduce that subsidy so the Federal Government still subsidizes these people, but it only subsidizes them at 25 percent?

Now, I realize people could say, well, you could pick a much lower number, and you could take a tougher cut at this. It is the issue of principle that we would like to see joined and debated. The politics of doing more on this have been difficult for all to deal with.

In the farm area, the same point is true. For people over $125,000 in non-farm income, we have said cut their deficiency payments, eliminate them, make them no longer eligible. These are not small farmers. These are not farmers. These are people whose non-farm income is over $125,000 but who are also getting farm subsidies on the side.

Student aid, this is not a deficit reduction measure here. What we are proposing in student aid is to increase Pell grants for people at the lowest end, the poor. And then if the argument comes back, well, aren't you taking away from people in the middle, the answer is no. We would like to increase the loans for people in the middle.

What we are basically doing is changing the mix so that poor people don't start out in life with an enormous burden of debt. Give them more of the grants, and give people in the middle more of the debt where they have a better chance of repaying.

School lunch. This one I know you may say is an old familiar one. No, we have changed it this time. We are not proposing to save any money with this change. In the past, we have tried to use this for deficit reduction. What we are are saying is retarget the subsidy. Allow people to continue to be subsidized, but cut the size of the subsidy for the wealthy, and take the savings and put them in for people in the 130 to 185 percent of poverty range.

Veterans' dependents, we applied the same principle in another area. Survivors' benefits now differentiate by rank. We are saying over time let the survivors of lower-ranking military people work their way up to the same benefit levels as survivors of the higher-ranking people.

We have other small proposals in this area. There is a chapter in the budget which deals exclusively with this subject.

Let me now turn to the broader list of reform areas. I will quickly touch on eleven. We have given emphasis to education reform. The Education Department budget in our proposal goes up by $2.7 billion in outlays, but a large number of people have said that isn't the way to think about education, to look only at what the Federal Education Department is doing. At least with respect to Federal ex-

penditures we ought to take a look at other headings and examine what we are doing for children generally.

SELECTIONS FROM THE REFORM AGENDA—WITHIN THE FLEXIBLE FREEZE FRAMEWORK[1]

(1) Education Reform

(2) Research and Development

(3) Financial Sector Reform

(4) Incentives for Saving and Investment

(5) Entitlement Reform

(6) Health System Reform

(7) Drug Abuse Reduction

(8) Housing Reform

(9) Transportation Infrastructure Investment

(10) Government Management Reform

(11) "States as Laboratories"

[1] Proposed total governmental spending for 1992 is 2.6 percent greater than 1991 (i.e., growth is less than the inflation rate).

So we for the first time tried to pull together a children's budget, a budget in terms of Federal expenditures that benefit children. You will see that presented in the introduction and then in a chapter of its own, $87 billion, a 9.5 percent increase in investment in children. That includes $2.1 billion for Head Start, an increase of $100 million. It includes $732 million for the new child care block grant that the Congress enacted last year, on down a long list which is itemized in the introduction.

In addition, under education we have proposed $690 million for a new Educational Excellence Act to accelerate the process of reform, working with the governors but providing extra incentives. Two hundred million dollars of that is to encourage increased choice in school systems by creating an incentive fund where States and localities that increase the availability of choice in education, especially for the children in Chapter 1 areas, will receive a benefit in the form of a bonus from this incentive pool.

Research and development I have already touched upon, $75.6 billion, a record high. Of that, $13.3 billion is for basic research, also a record high. Overall, an $8.4 billion increase, a very substantial increase. I think Senator Hollings might be pleased—to pick one who I know has an intense and long-standing interest in this area—that we have specifically recognized that over a period of time our investment in applied civilian R&D has lagged as a percent of GNP. We are beginning the process of correcting that. We are not crossing into the area that would be termed industrial policy, but we are doing, I think you will find, interesting things in high performance computing, materials processing and so on down the list that is itemized in the R&D chapter in the budget.

Financial Sector Reform. You will see that we build into the baseline of the budget a $22 billion negative balance in the bank insurance fund by fiscal year 1996. That is built into the numbers you have seen. Today Secretary Brady will be putting out the proposals to address the financial service sector. I won't go over those here. He is briefing independently on them. They will contribute to the improvement in the banking sector over time. The recapitalization of the bank insurance fund is still being worked out with the FDIC and the relevant communities.

Incentives for saving and investment. Family savings accounts, capital gains, penalty-free withdrawal for first-time home buyers: these are proposals of ours that you have seen before and, as Senator Sasser suggested, you have not raced to enact, notwithstanding the fact that we know there are 63 votes out there. We have just had a little trouble getting a vote.

Entitlement reform. Entitlement reform I have already alluded to and will be happy to respond to further questions. The entitlement reform proposals are obviously not just the ones that I touched upon in the previous charts. They are itemized in Table II-9 in the introduction which is before you.

Health system reform. We continue to implement the physician payment reform discipline. We go a step further and take more away from certain doctors' reimbursements. But, more importantly perhaps, we have a proposal built into the budget to accelerate malpractice reform. And insofar as we are spending money that is discretionary money, we have a special emphasis on prevention

with not only increases but ways we think that pull together the resources better to do things like reduce infant mortality, increase immunizations and so on.

Drug abuse reduction. $11.7 billion is a substantial increase. We have last Thursday or Friday put forward the next stage of the drug strategy which is available for your examination.

Housing reform. The Congress last year enacted a new approach to housing, including Project HOPE and the HOME Program, and we fund both. We put $2.1 billion into HOPE, the maximum that the statute allows. We put $1 billion into HOME.

Transportation infrastructure. Transportation, highways: we go from $14.6 billion in obligations in 1991 to $16.0 billion in 1992, up to $20.3 billion in 1996, and over the period spend more than is coming into the Highway Trust Fund on a cash basis.

Government management reform. This is a subject that bores a large number of people but is nonetheless extremely important. I call your attention to a rather large chapter on this subject. I think we are, in fact, making slow but steady and significant progress in this area.

Finally, States as laboratories. We not only continue to try to increase flexibility in the programs that exist to provide ways for the States to be more innovative and so on. We also, as you suggested, Senator Domenici, and it is by now well known, have proposed to turn back a whole host of programs to the States. We have been working with the Governors and yesterday with representatives of cities and counties and other interested parties to try to come up with a mutually agreeable list of programs to turn back to the level that can be more innovative, closer to the people, and more efficient.

PROGRAM LIFE CYCLES

("Not All Federal Programs Should Become Immortal")

- **Some should *INCREASE:***
  - —250 Programs
  - —Plus $17.8 billion
- **Some should *DECREASE:***
  - —109 Programs
  - —Minus $8.3 billion
- **Some should be *TERMINATED:***
  - —238 Programs (3,591 Specific Projects)
  - —Minus $4.6 billion
- **Some should be *TURNED OVER TO STATES:***
  - —$15 billion target

Note: **Above are selections from 1992 Domestic Discretionary Budget.**

The last chart, and then I will sit down, and also stop talking. Senator Domenici referred to program life cycles, as did the President, and said not all Federal programs can become immortal. We agree. Obviously some programs have increased. Thre are two hundred fifty major program increases. A lot of little ones also increased that aren't in this number. Two hundred fifty programs increased for a plus $17.8 billion. This is within the domestic discretionary category. Some should decrease. We say 109 programs. We specifically identified them, in the budget that you have available, to be minus $8.3 billion. We say some should be terminated altogether. Two hundred thirty-eight programs are specifically identified for termination, 3,591 specific projects we propose for termination. That saves $4.6 billion and helps finance some of the increase. Then we say some should be turned over to the States, and we have set a target of $15 billion, and you have available before you a list of programs that we say is a good starting point of $21 billion from which to select the $15 billion.

So with that by way of introduction, Mr. Chairman, I would say that I appreciate the comments you made about our presenting a budget within the framework of the budget agreement. We have done so. We think it very important to stay within that framework. Obviously, we and the Congress will not make exactly the same choices within that framework. But we have tried to make our choices absolutely explicit and have put them out in detail for you to examine and would be prepared to discuss any and all of them with you and to work with you as we proceed.

I apologize for the long introduction, but thank you very much for the opportunity to present the President's budget.

Senator EXON. Mr. Chairman, could I ask just one brief question?

Chairman SASSER. You may.

Senator EXON. That $2.7 billion that you said increased in I believe education, is that above inflation or just from last year's level?

Mr. DARMAN. No, that is from last year's level, Senator.

Senator EXON. So it is not real, it is just an increase above last year's level disregarding inflation costs?

Mr. DARMAN. But it is also an increase relative to inflation but not by the same amount. The baseline in outlays is $24.8 billion, and it goes up to $27.5 billion. So it goes up faster than the rate of inflation.

Senator SIMON. But I hasten to add, $1.6 billion of that is entitlement guaranteed student loans.

Mr. DARMAN. Yes, Senator, some of it goes to that, and that is a good thing.

Senator SIMON. OK.

Mr. DARMAN. We would agree, wouldn't we?

Senator SIMON. We will get into it shortly.

Mr. DARMAN. OK.

Chairman SASSER. Mr. Director, I thank you very much for your presentation here this morning. I am going to ask one, I hope brief question, and then perhaps turn to Senator Domenici and then turn to the other members for their questions. They have been waiting patiently, and I am sure that they are eager to ask some questions.

One thing comes to mind. This budget that you presented—which we have in patriotic colors this year, red, white, and blue, and I want to commend you on that, Mr. Director. I think that is right in keeping with the times here. But in reading this budget, which is over 2,000 closely reasoned pages, I find really virtually nothing about the war that is going on and about the recession. They are both barely mentioned.

Now, I understand that you predict a short recession, and, of course, your budget was put together before probably more gloomy assessments were being made about the recession that have been made just within the past week or two. You are also predicting that allied contributions are going to pay for the lion's share of this war in the Persian Gulf, and you set the total allied contributions, as I recall, at $50 billion.

Now, so far, of that $50 billion, according to information we have here at the Senate Budget Committee, we have only received $5.8 billion from our allies. To be fair about that, that $5.8 billion comes in from the $10 billion that was pledged for calendar year 1991. But any way you slice it, we are still way short, either by looking at calendar year 1990 or by calendar year 1991.

Now, the question comes, if there is a significant shortfall on the part of our allies, and in calendar year 1990 there was almost a 50 percent shortfall, if there is a significant shortfall, what are your contingency plans to cover the cost of the gulf war? You are saying, some are saying it could range as high as $70 billion or $80 billion.

Mr. DARMAN. Thank you, Mr. Chairman. Could I note with respect to the recession that our forecast was adjusted downward very, very substantially, to the point where our forecast is now actually more pessimistic than CBO's. It is just about exactly the same as the consensus forecast of the blue-chip economists—which, by the way, should not necessarily give us solace because they are often closer to each other than to being correct. But, nonetheless, we are no longer the rosy forecasters. We are, as I have noted, pessimistic relative to CBO and right in the dead center relative to the outside private forecasters, even now.

With respect to the war, Mr. Chairman, I wonder if I could divide the problem into three parts this way. With respect to the period from August 2nd to December 31st, the calendar 1990 involvement, from the time of Saddam Hussein's invasion to the end of the year, we calculate the costs, including in-kind costs, of the U.S. action, the incremental costs as we interpret them to be defined in the budget act, we calculate those to be $11.1 billion.

Chairman SASSER. When you say incremental costs, Mr. Director, you mean costs over and above what the Department of Defense would be spending in any case if they weren't deployed in the Middle East.

Mr. DARMAN. Exactly. Of that $11.1 billion, we received commitments to cover $9.7 billion.

Chairman SASSER. How much cash have you received?

Mr. DARMAN. Of that, we have received in cash to this date $5.3 billion, and we have received in-kind payments of $1.8 billion, for a total of $7.1 billion received. Now, $6.6 billion should be compared with the $11.1 billion costs because both of those numbers include in-kind.

If, as we expect to be the case, the rest of the payments for that period are made, then the total U.S. cost for that phase will be $1.4 billion. Now, the Congress already appropriated $2 billion for that last year. We believe the foreign contributions will come in. Of the ones that are outstanding, in one case they are outstanding because we haven't provided them the bill, and that is a very substantial portion of this. Obviously we should provide them the bill, and we will.

Chairman SASSER. Well, if you need any help in drafting that, we will be pleased to assist you here. [Laughter.]

Mr. DARMAN. I feel very confident that we will end up in a situation where, through the end of last year, last year's $2 billion appropriation plus what we will have received from abroad, will have paid for Desert Shield. So that is point one.

Now we get to the war stage.

Chairman SASSER. Can I just stop you there for just a moment and ask you one question? As I understand it, for calendar year 1990 the Japanese pledged $2 billion. As of December 31, I am advised that they had contributed about $370 million of that $2 billion in cash, and some in-kind contributions which consist of four-wheel drive vehicles that probably total somewhere in the neighborhood of around $100 million. Is that correct, or do you know?

Mr. DARMAN. My records suggest that for the period we were just talking about—through December 31?

Chairman SASSER. Yes.

Mr. DARMAN. The Japanese committed to the U.S. $1.74 billion, of which we received $866 million in cash, $206 million in-kind, for a total of $1.072 billion. So they still have outstanding approximately $600 million for that period. But we fully expect them to pay that. It is a firm commitment.

Now, if I could move to the second stage of the costs related to Desert Shield, the stage that we are in now that involves combat, there we have, as you have noted, additional contributions pledged. And those were pledged on a quarterly basis; that is, the request that was made to the countries in question was explicitly a request to cover only 3 months, through March 31st. The relevance of that is that if the war costs go on beyond March 31st, it is explicitly understood that there would be further contributions expected. So for the quarter that we are now in—and I emphasize the fact that March 31st is strictly an accounting matter, a calendar quarter; it has nothing to do with any military plans—this quarter, we have pledges of $41.780 billion to cover the costs. Now, that is for one quarter, 3 months.

When you see numbers like $76 billion, I think that is at the high end of the range in CBO estimates, that is for a war scenario over a much longer period of time. I am not saying it is an unreasonable number, but I am saying it is for much more than a quarter. I think most people would say that $41.8 billion for a quarter is going to turn out to be a very, very substantial portion of the actual costs incurred.

Now, I haven't yet gotten to the fact that we included in that first chart you saw—the deficit estimate and the table you have on the deficit—$15 billion of U.S. costs for the war. That is already in the deficit.

Chairman SASSER. That is fiscal year 1992 deficit?

Mr. DARMAN. Well, actually $15 billion is budget authority and $8.2 billion of it roughly is spent in 1991 and another $4.6 billion is spent in 1992, and $2.0 billion thereafter. The cost of $15 billion accounted for in the deficit numbers hasn't yet been appropriated by the Congress, but it is accounted for in the deficit numbers you have seen. So if you were thinking of it this way—and I am not saying it is the right way to think about it—you have $41.7 billion pledged and you have $15 billion that is already built into the deficit. If you could imagine getting from where we are now to the end of the war, and bringing people back home, having spent $66.7 billion or less in calendar year 1991 for the incremental costs, if you could do that, then it is fully accounted for in the deficit, assuming these foreign contributions come in, which is the next part of your question.

Here I would only say we didn't go around—I didn't do it myself, Secretary Baker and Secretary Brady and the President did—and seek this "responsibility sharing," as we have termed it, for this phase until the conflict broke out in the third week of January. So it is natural that the payments aren't in yet, but there is a specific payment schedule agreed to, and we expect that to be honored. I am confident it will be honored in the case of several countries. In the case of the Japanese, they have made the commitment at the level of the Prime Minister and the Finance Minister, but they have not yet voted it through the Diet. I don't believe that vote will take place until the third week of February.

Chairman SASSER. So they have to approve a tax increase in the Japanese Diet to meet this pledge of $9 billion for calendar year 1991.

Mr. DARMAN. Either that or do it with borrowing. But I would make one slight amendment to the way in which you introduced the subject, if I could, or at least I would propose one. I accept yours; I propose a slight difference in the way of thinking about it. You used the phrase "pass the cup," and we use the phrase "responsibility sharing." I think both are appropriate. The reason that I would say responsibility sharing is that this isn't charity. This is in the Japanese own interest. This should be viewed as a thoroughly sound investment on their part and the part of all the other countries who are contributing.

Chairman SASSER. Well, I couldn't agree with you more on that point, Mr. Director. I think it is a very sound investment for them. And if they can protect their oil supply for $9 billion and no loss of Japanese life, I would say that is one of the greatest bargains in the history of mankind, and they ought to rush to that bargain sale just as far as they could. But from what I am understanding, they are dragging their feet somewhat.

The question is this, and then I will return to Senator Domenici: In the event that this scenario that you painted for us here does not come true, in the event the Japanese Diet defeats the effort to raise $9 billion to pay their share in taxes, which I think the likelihood of that is at least 50–50, in the event the Germans don't come forward with their payments, as I understand they have been very reluctant to do in calendar year 1990, what, if any, contingency does the administration then have for dealing with the shortfall?

Mr. DARMAN. Well, Senator, I am afraid I can't give you a satisfactory answer because the largest portion of this $41 billion is contributed by Saudi Arabia and Kuwait. They are each pledged for the next quarter at $13.5 billion for these 3 months, the 3 months we are in. So that is $27 billion right there. They pay on time, the 15th of the month. They pay. So I don't think that this is speculative. No one is suggesting that Saudi Arabia doesn't have a continuing interest in paying these bills, or Kuwait; and they both have the capacity.

With respect to the Japanese and the Germans, we are at this stage saying we have firm commitments from the head of government or head of state, and we believe those should be honored and would be honored, taking them at face value.

Chairman SASSER. So would it be fair to say at the present time the administration has no contingency plan in the event these payments are not made?

Mr. DARMAN. I wouldn't like to say that because that would be the unattractive way of putting it. I would rather say that we have an excellent plan which is going well in that we have extraordinary contributions, far more than most people would have expected. In our budget, we assumed only a 50 percent contribution from abroad at the time the budget went to press, and we have come in at roughly 90 percent through December 31st. And we don't know what the costs will be for this quarter, but foreign contributions will be more than 50 percent for sure. So far things are going better than we had planned. So rather than say we have no contingency plan, I could say that we are actually doing better than we had originally assumed.

Chairman SASSER. Just leave it with this and say the administration actually has planned on making money on this war? Maybe we can get enough here to apply to the deficit.

It appears to me that we are sort of keeping our fingers crossed and hoping that all members of the coalition are going to come forward with the payments that they have promised. Unfortunately, the record of some of the members of the coalition is not very good in that regard. Some are very good. The Kuwaitis do come forward and pay on time. They ought to pay on time. This is an effort to give them back their country. In my view, they ought to be paying more than they are paying. I think the Saudis ought to be paying more than they are paying. But I don't think we can just operate under the assumption everybody is going to pay up.

I have taken more than my fair share of the time, and I will turn now to Senator Domenici.

Senator DOMENICI. Thank you, Mr. Chairman.

Mr. Darman, let me just take the issue that was discussed for a moment by the Chairman, as his question, and ask you for one moment two questions. Obviously Congress, on a bipartisan basis, has said it is fair and right that others pay a significant portion of the cost.

I don't think there is any question that the administration heard that. You mentioned in your remarks that the two Secretaries and the President had sought to carry out this notion of significant contributions from our allies.

First, the President seems very committed to this problem in the Middle East. He is just, fair, very emotionally involved, and very strong in terms of America's role there. Does he feel this strong on the issue of whether or not our allies should pay this share we have been speaking of? Has he ever alluded to that in your presence?

Mr. DARMAN. Oh, yes, definitely, Senator. He feels extremely strongly and has, himself, worked this problem directly. One of the reasons that the contributions have come in at levels and commitments higher than we had originally forecast or expected is the President's personal involvement talking to the heads of state in question.

Senator DOMENICI. Now, at a point in time, I assume the administration will go into more detail as to the arrangements with these countries—what in-kind means and how that is forthcoming and the like, so that we will all understand it—but do you, as Budget Director, feel confident today with the commitments that have been made and the accounting that we are using as a part of this process?

Mr. DARMAN. Yes; I think that the accounting is sound. We are legally obliged to account for everything we spend and all in-kind payments we receive.

We and GAO have started to work on this cooperatively so that we would not end up in a situation later with people having an awful lot of debate about the accounting associated with it. I can't say that's gone perfectly, but at least I think, given what's going on, we have a reasonable degree of confidence in it.

There's an inherent problem, as you well understand, in that the first job of the people who are over there is not to do their paperwork. So there's some lag in the data we get, but I think it's pretty reliable.

Senator DOMENICI. On a specific substantive issue that pertains to the way you're budgeting, could you describe briefly what was the premise you used to stop and terminate 3,850 projects? Is there some generic approach? I hope there is. I hope that was not a purely subjective decision.

And, secondly, in programs that were terminated or cutback, was there an approach to them that was general in nature that caused their reductions and others to increase?

Mr. DARMAN. Yes, Senator. There was and there is a chapter in the budget that refers to program terminations, decreases and increases. And in that, we attempt to explain how we went at this, analytically.

There's one area that is relatively easy although I don't think it's relatively popular with the Congress. That is the area sometimes known as "pork."

In that particular area, I said let's not call pork any old project we don't like, or a project associated with some member or other with whom someone has had a problem. Let's try to apply some uniform criteria. So what I said—and this is arguable I recognize—let's take the standards that are set in law, to the extent that they are clear; identify those. Then take the standards for awarding projects that are specified in regulation or some administrative requirement that has standing, that is a formal one intended to be

uniformly applied. Any project that got funded that did not meet those standards we would classify as, colloquially speaking, "pork" and propose for termination.

Now, the reason that, of course, the Congress would disagree is that those projects were funded with congressional authority. Congress made an explicit determination that it wanted to deviate from the standards in law or in regulation and went ahead and funded these programs or projects. But we said, let's go by what's in law and in regulation. So we itemized those as one section of the terminations.

The others involve either a program evaluation which suggested that the project or program was not doing what was intended, was not effective; or, in many cases, a judgment that it was lower priority along the lines that I tried to suggest at the start here.

So, there are multiple criteria. The clearest are the ones in law, or regulation, but applying that standard may not satisfy the Congress.

Chairman SASSER. Thank you, very much, Senator Domenici.

According to my list here, in time of arrival, Senator Conrad would be next.

Senator CONRAD. Thank you, Mr. Chairman.

Thank you, Mr. Darman.

I'd like to go back to last year and the projections that you gave us at that time. In looking at the Director's introduction to the budget of last year, you were then looking at a base-line deficit of $100.5 billion, were advocating policy changes of $36.5 billion which you then projected would give us a deficit for fiscal year 1991 of $64 billion.

As I recall the summit made about $40 billion of policy changes, which according to those numbers should have given us a deficit of about $60 billion or there abouts, based on your projections last year.

Now we are told that the 1991 budget deficit is going to be over $300 billion. Can you clarify for us the differences between a projection of $60 billion and now a reality of $300 billion?

Mr. DARMAN. Yes, I can try to, Senator Conrad.

First of all, last year's projection did not include extraordinary working capital requirements for deposit insurance. It had deposit insurance working capital at zero. And the budget had a note which said that this was a matter of dispute as to how it should be scored and that, although we didn't include it, it could turn out to be an additional cost, depending on how it was scored, of about $140 billion.

Subsequently in the budget agreement we decided, after debate, that deposit insurance working capital would be included in the scoring now—so you are not comparing apples and apples.

If you were to take last year's baseline deficit of $100 billion and include the actual estimate for deposit insurance you would have to add about $106 billion. So that would get you up to $206 billion. Then between last year and now the economic forecast has changed radically, and that is the single largest additional element of change. Receipts—I'm going from memory here and would be happy to give you a detailed table that would break this out—receipts, I believe, are off $87 billion, relative to that particular fore-

cast. The largest portion of that is for reasons related to the economy.

And there are also automatic spending increases related to the change in the economy. The combination of those will account for almost the entire difference.

So one reason is accounting for deposit insurance; and the second is the change in economic estimates. Here, I would point out, that no outside economists foresaw the recession last year. When we were said to be too "rosy," it was by tenths of percentage points, not by direction, not a sign change positive versus negative.

The Budget Act changes the incentives in any case for estimating. We no longer, and you no longer, have a benefit from rosy estimates. So, I think, partly for that reason you find that our estimates now are pretty much in the middle of the pack and you probably have not only an adjustment for the change to recession but also an adjustment for a little bit more realism.

Senator CONRAD. Let me just say for the purposes of the record, at the time that you made those projections last year Senator Hollings and I, and others here, as well, said that we thought they were far too rosy; off by a factor of perhaps as much as 100 percent; and some ridiculed us for suggesting that. I think the record should show that, in fact, there were some, at least, who thought that those projections were off by a country mile.

Let me ask one other question and that simply is, why shouldn't we read this budget as an assault on rural America? As I go down the list of who gets hurt: Crop insurance takes a very big cut on a percentage basis. Rural electrics have their direct lending authority cut by 60 percent. Power marketing authorities get hit badly. It means a rate increase, I am told in my State, of 20 percent for rural consumers of electricity. Highway distribution formulas are changed in a way that is very unfavorable to sparsely populated rural parts of our country. Low-income heat assistance cut dramatically and shifted towards the northeast. The line goes on an on. The medicare cuts affect disproportionately the rural hospitals.

Why wouldn't we be correct in reading this as an assault on rural America?

Mr. DARMAN. Well, if I could respectfully suggest you would be incorrect because we never ever, ever had anything remotely like such motivation. I think you have to look at each of the areas you have mentioned on its own merits.

Crop insurance we're proposing to reform in a way that we think is sensible. The REA change that you refer to is really largely a function of switching from direct to guaranteed loans. Admittedly that does change the interest rate. But if you look we have a table in the budget that shows the relative subsidy for different kinds of loans to different parties and I think you will find that the REA loans are already receiving a very large subsidy, and still would be if you gave them Treasury rate financing, which is all we're proposing to change it to, but it is not quite so large a subsidy.

PMAs, Power Marketing Administrations, the largest portion of that is not in your area, it's Bonneville. And even after our proposed reform, they would still be getting a subsidy and they would still have the lowest electricity costs in the country.

Low-income housing, this is partly a——

Senator CONRAD. I was talking about the low-income energy assistance program.

Mr. DARMAN. Excuse me, LIHEAP, this is partly a difference as to the basic principle underlying the program in the first place. In previous budgets we proposed deeper cuts in this program than we have in this one. We're proposing $925 million.

Senator CONRAD. Yes, $925 down from a $1.4 billion.

Mr. DARMAN. And all I can tell you with respect to that one is I think you can get a good argument on the merits as to the rationale for the program in the first place, and some have suggested that it ought to be zero, and some of its advocates are pleased that we have come in, at least, at almost $1 billion.

In medicare, we are reducing the disparity between urban and rural hospitals over time, which I think would be something you would view favorably; and there's nothing in our medicare proposals that I'm aware of that would peculiarly adversely affect rural hospitals. I'm sure someone will question the change in the reimbursement for training hospitals, but those are largely urban. In fact, people from urban areas complain that in proposing to do that we're hurting urban hospitals more than rural hospitals.

So I really don't, if you will pardon me, accept the premise of the question. We have no intention of mounting an assault on rural America, or anything of the kind. With respect to the underlying farm bill, we're not proposing to reopen that at all.

Senator CONRAD. Well, the damage was done on the farm bill. Let me just conclude by saying the cumulative effect here really looks to be at least an assault on rural America. We could go point-by-point through that, but we don't have time to do it. I hope we will have a chance to review that here, in the Budget Committee.

Senator HOLLINGS [presiding]. Senator Symms?

Senator SYMMS Thank you, Mr. Chairman.

Mr. Director, I would like to congratulate you and the President and the people who have put this budget together because my appraisal of this budget is that you have made a serious effort to strike at the heart of our fiscal problem, which is government over-spending, and you force people to make choices. I think that's very good. I think we ought to also make it very clear that the problem is and always has been government over-spending, not a lack of revenue.

There are massive amounts of new revenue each year. All one has to do is look at the revenue flows to Treasury that I've witnessed on the 10 years I've been on this committee. They go up and up and up and up.

And the American people do not believe, and I do not think they are under-taxed. In particular, I think that non-defense spending has been the problem. It's very clear if one analyzes it.

So, I guess I would say at the outset, I agree with the budget, in so far as it says we don't need new revenues; we don't need new user fees; we don't need a war tax; or on S&L bailout tax; or any other kind of a tax increase.

The fact is, by holding spending growth below the projected rate of inflation this budget slows spending and will eventually, if complied with, or if close to complied with, reduce the deficit.

So I think it's real. And I think the restraint is real. And I think the issue here and the debate in this committee should be about priorities.

Now, some of us, notwithstanding the love affair that some parts of the American news media have had with Mr. Gorbachev, as have the Nobel Committee et al, think that the defense numbers may be overly restrained. I happen to be in that category, but that's a debatable issue, as Senator Domenici pointed out at the beginning.

There was an agreement made and Congress has spoken on it. Defense spending is clearly going down, I believe in this budget, to a record low. As a percentage of our GNP it goes down to where it was right prior to World War II and right prior to the Korean War. I hope there is not an omen in this.

I might just say to the Chairman, I guess he's not back in the room, but with respect to the effort to get our allies to help cooperate and pay for the war effort, I congratulate the Administration on that and I hope that you are successful. I think you will be successful because there is a common interest in other countries like Japan and Germany and others in paying for a portion of this war effort. But we should not be naive to think that it isn't in our interest also to rid the world of the menace of Saddam Hussein. We are going to have to expect that we will have to pay a part of that burden and we will be the beneficiaries of a better world after this war comes to its conclusion.

But we have to get on with setting priorities and that's what the President's budget has done. It's going to force us to make choices. Now, some people around here like to complain about every reduction in social spending, but cuts have to be made somewhere. The President, in my opinion and you, Mr. Director have bellied up to the bar and made some choices.

So it would be refreshing if the folks who are complaining about the President's proposed cuts would come up with some cuts in social spending of their own, if they don't like the ones that you have selected.

Now, there's a small problem with the President's budget. Under last year's budget deal caps were set on discretionary spending. And the conventional wisdom around here is that the caps were not just ceilings but they're also floors. And that Congress will never spend less than it can under the law.

Now, this is like having a credit card limit on a credit card. A teenager might think they can go to the credit limit. So what we have to do is keep from maxing-out on the credit card limit. It's not an act of responsibility to keep from charging as much as the credit card will allow.

I hope that Congress will make an effort to control itself so that we do not use those caps as floors, but that we actually come in under the caps. Now, we may lose that argument, but I think it's an argument that is well worth making.

Now, Mr. Darman, I guess I would just make one suggestion before I ask a question, if I have any time left, and it's a friendly suggestion. If anybody says to you that this budget is unrealistic, that we have got to have presidential leadership, that we have got to get the President involved in some kind of a summit conference

again, in some informal negotiated discussion, consultation or whatever—my urging to you would be to grab your wallet, run for cover, and head for the nearest door, because it is not the right way to enact a budget.

Now, if I have time for a question—on chart four—and I have a series of questions and I will get to them in my next round—where you talk about long-term investments. One of the things that happened in last year's budget was that 2.5 cents a gallon of fuel taxes went to non-transportation spending. As long as the spending caps are not changed on the transportation spending from the trust funds—on transit and trust funds for highways—would it really have any negative impact on your budget proposal if we put that 2.5 cents back into the trust funds? The two cents would go highways and one-half cent into transit.

Mr. DARMAN. If the caps were not changed?

Senator SYMMS. From what you're proposing.

Mr. DARMAN. If you kept the caps exactly the same?

Senator SYMMS. You see, Mr. Larson's been over to my office and given me a very good briefing on the highway proposal that the Administration is pushing. I think it's a very far-reaching and a very positive plan and it calls for, by the end of the program, $20 billion spending on highways which is part of this budget.

If we changed the 2.5 cents and did not change those caps for the short-term, would it have any negative adverse impact on your proposal?

Chairman SASSER. Mr. Darman, could you give us a relatively quick answer, because we're trying to limit Senators here and get to other Senators as quickly as we can.

Mr. DARMAN. If the caps were not changed, it would not have an adverse effect. That does not mean that we would support it. Because what would happen is that you would start to build up the balances even more in the trust funds, or else you would start to squeeze out other investments in domestic discretionary if you raised the obligation limits from the trust funds. One or the other of those would happen.

But to answer your question narrowly and briefly, from a deficit standpoint, if you didn't change the caps, it wouldn't change anything.

Senator HOLLINGS [presiding]. Very good. Senator Simon?

Senator SIMON. Thank you, Mr. Chairman.

You have learned, Mr. Darman, at these initial sessions you give the broad picture and then you have to listen to us, more than having questions. Just a few reactions.

Number one, whatever the cost of the war—let's just say it's $15 billion—we got to pay for it, both from the viewpoint of economic policy and social policy.

It is not wise to have a war that we don't pay for on an ongoing basis, just as Harry Truman did with the Korean War. We should not be in a position where we're saying, the only people who are going to make sacrifices are troops in Saudi Arabia and their families. We're not willing to make any sacrifices at all.

Number two, medicare. I'm very much concerned. Medicare is 10 percent of the total budget outlay and is asked to take 40 percent of the reductions here. I talked this morning to Father Baumhart,

the President of Loyola University, and they had a research hospital. This past year they lost $28 million on medicaid, and $24 million on medicare.

He said, I feel like Robin Hood, we are taking from those more fortunate in order to subsidize, but they can only keep that up so long. Twenty-two hospitals in Illinois closed in the last 5 years.

And then in the education area, I am concerned. Now, it is true there is a $2.7 billion increase but $1.6 billion of that is guaranteed student loans. When you exempt the student loan program you're talking about 3.7 percent increase or less than the rate of inflation. And yet, everyone, including the President of the United States, says, education is one of the greatest needs that we have.

In the Pell Grant Program, it has increased $400 million but you take away $527 million from the work/study program, from the SEOG, and from the Perkins programs. So the net is you are taking away from students in those areas.

Library programs cut by $107 million, a 75 percent cut; Chapter I Handicap goes from $148 million to $125 million, a cut of $551 per pupil down to $462. Indian education is increased 2.7 percent when clearly that is a great need.

We hear from the Defense Department right now we need people who speak Arabic. We hear from the CIA, they need people who are specialists and yet, foreign language assistance program for elementary and secondary schools is zeroed out in this program.

Anyway this is a buckshot at you and I will get a buckshot in return but I welcome your response here. Let me just add, Senator Domenici said that there are areas where we do agree and there's no question about that. There are some proposals in this budget that I think are good proposals and my hope is that we can, before this is over, come to a bipartisan agreement, but there are serious concerns that I have about where we are right now.

Mr. DARMAN. Thank you, very much, Senator Simon.

Let me, as suggested, try to be brief. As you know, these are large topics.

Senator SIMON. Right.

Mr. DARMAN. So I apologize. First on the war and paying for it, I should be clear that $15 billion is what is built into our deficit forecast built in already. I realize I ought not to be misunderstood on this. I'm not saying we can reliably predict it will be $15 billion.

Senator SIMON. I understand that.

Mr. DARMAN. We don't know the way the war is going to go. We will have to see. All I'm saying is that for the next quarter I think we have got it satisfactorily financed, and have satisfactorily financed the last 5 months.

Senator SIMON. But what I'm really asking about is the principal— whether it is $15 billion, $20 billion, $30 billion, are we going to adopt as a policy the only people who are going to sacrifice are going to be people who are in the armed forces and their families?

Mr. DARMAN. Obviously not. But I think that if you were to ask which would you rather have make the financial sacrifice, foreign contributors who do not have people participating or foreign contributors, who are front-line and have the capacity to pay and have their countries directly at stake, versus Americans, you would prefer to have the former.

Senator SIMON. Clearly.

Mr. DARMAN. So our emphasis is on the foreign.

Senator SIMON. And we're in agreement on that. But the question is the residue of what may need to be paid—whether we are going to face up to this, or we're just going to say we're going to pass that on to our children and our grandchildren.

Mr. DARMAN. Right now what I'm trying to say is that the residue would appear to be manageable. If the pattern of the war were to change and go in directions people are not predicting, or at least we are not assuming, then I think you would have to review the issue. But I would say I think most people would agree that we shouldn't be raising taxes at this point, given our own domestic economic situation. And in a sense, if you are saying well, then, you're paying for any residual with debt, I would say, yes, to the extent there is a residual, you are paying for it with debt. But this is one of those debts where the future generation actually benefits. From a lot of the debts we incur, the future generation does not benefit.

If I could just quickly touch on the other two subjects you raised, medicare—the Loyola example is because it is a teaching hospital, and that is a running dispute we have, as you know. But GAO agrees with OMB on what should be the reimbursement rate for teaching hospitals and so does the outside independent commission called PROPAC that looked at it.

Of the twenty-eight hospitals closing in Illinois, most of those are rural, and the reason that they are closing is partly related to the decline in population in the area, and other problems they are having. And I would just note we don't change the capital reimbursement rate at all for hospitals in our proposals; we live by the budget agreement. So those hospitals are not adversely affected by what we're proposing.

Senator SIMON. If I could—and I know the red light is on—but hospitals like Saint Anne's on the west side of Chicago and Provident on the south side of Chicago, urban hospitals in areas of great poverty are the ones that are really hurting in my State.

Chairman SASSER. Mr. Darman, if you could limit your answers as much as possible—I don't want to cut you off, but we do have a time problem.

Mr. DARMAN. I'm trying, Senator, to strike a balance. I was asked questions about the war, medicare and education.

Chairman SASSER. Do the best you can.

Mr. DARMAN. Briefly, on education.

Senator SIMON. OK.

Mr. DARMAN. Our emphasis has been more on funding reform initiatives within the Education Department, or at least what we define as reform initiatives, and this is perhaps an honest difference between us, and it will be worked out in due course. Math/science education, perhaps we agree on, does get emphasis with us, as do the measurement programs. But the one point I would make in concluding on this is I do think that education should be conceived to be broader than just the Education Department. And I think the investment, especially in younger children, that is in this budget is impressive. It is a 9.5 percent increase. It is a greater increase than the rate of inflation, and it comes under a host of head-

ings, many of which responsible analysts believe will have higher payoff than some investments in conventional education programs.

And I suspect you would agree, when you look down the table, that I have presented in my introduction of $87 billion worth of investment in children.

Chairman SASSER. Thank you, Mr. Darman.

Senator Brown.

Senator LAUTENBERG. Mr. Chairman, may I make a suggestion. In fairness to those at the end of the list, the red light means "stop".

Chairman SASSER. We'll attempt to enforce that, Senator Lautenberg.

Senator LAUTENBERG. Thank you.

Chairman SASSER. Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

Mr. Darman, we appreciate your coming here today, and I think more than anything appreciate your proposing a budget increase that is less than the rate of inflation. It is the first time, at least in my memory, that we have had an administration willing to do that.

In looking through the figures, though, I see some areas that I'd like your comment on. You have proposed a 2.6 percent increase in overall spending and outlays. On page 27 that is a summary of proposed outlays by agency, you proposed a $700 million increase in funds appropriated to the President, a roughly a 6 percent increase, that is more than double the rate of increase for the overall budget. Do you think that proposing an increase more than double what you are proposing for the rest of the Nation, for the President, provides the kind of leadership that you should show in budget restraint.

Mr. DARMAN. Thank you, Senator Brown.

The Funds Appropriated to the President accounts are, as I think you may appreciate, not what you might normally think of; it is not for things like running the White House. These accounts are really foreign military sales. It just happens to be accounted for under the Funds Appropriated to the President It is not in the State Department, it is not in the Defense Department. It is in an account called Funds Appropriated to the President, and that is what accounts for that significant shift.

Senator BROWN. That comment is helpful. I think you also appreciate the concern I have that leadership in this area should mean that the same rules that apply to the people should apply to the leadership, as well.

In that regard, you are proposing a $500 million increase in the Legislative Branch budget that appears to be, if I am calculating this correctly, a 20 percent increase, which was 7 to 8 times as big an increase as you are proposing for the rest of the budget.

Can you give us some insight as to why you proposed that large an increase?

Mr. DARMAN. Yes, sir, I can. Thank you for the question. [Laughter.]

Senator BROWN. I didn't mean it to be friendly.

Mr. DARMAN. The Executive Branch has no discretion with respect to the Legislative Branch requests for appropriations and

funding. We provide strictly a ministerial function. We take what we get from the Congress, stamp it, and send it back to the Congress. It is the Congress' budget.

The House request at plus 28 percent, and I made a courtesy call to the leadership and said, "Are you really sure that you'd like to have it appear that the House budget is going up 28 percent in a context where the budget as a whole is going up 2.6 percent?".

Now, if I could explain what I think you'll find to be the dynamics on this, or suggest what they may be, there will come a day when there will be a press release about how the Congress has funded itself at substantially less than its request. So maybe in the end it will get a 15 or 18 percent increase, but that will be lower than the number you've just mentioned.

We have nothing to do with this. We, in this particular area, are nothing but the delivery people.

Senator BROWN. I notice, in terms of making this fit—the chairman had earlier expressed concern about the health area—in looking at the agency summary, health and human services go up $39 billion which is more than the entire increase for the whole budget. That would make this area receive a substantial increase in spending rather than a cut.

Can you reconcile that apparent diversity in summarizations? As I read the total, we're going from $486.3 billion for health and human services up to $525.3 billion in human services——

Mr. DARMAN. Right.

Senator BROWN [continuing]. That means the rest of the budget took a cut while that got——

Mr. DARMAN. Right. The very largest two portions of that are in social security and medicare, which are automatic spending programs. We have not proposed to cut social security. In medicare, we have proposed to restrain the rate of growth, and notwithstanding the fact that we propose to restrain the rate of growth, medicare still grows substantially; so that is why you see those big numbers for HHS. The largest portion of HHS is "uncontrollable"; that is, most of its spending is mandatory, and only a tiny piece of it is discretionary.

Senator BROWN. One last question. I suppose if I were going to summarize the breakdown in the budget process, it would be a responsibility shared by both Congress and the Presidency in these last several decades. One disappointment I must tell you I have personally had in the last decade is that we haven't had a President willing to veto spending bills that were over budget.

Can you give us any assurances as to what recommendations you will give if Congress appropriates more money than what has been recommended in this budget? Will you recommend a veto?

Mr. DARMAN. Senator, we have a new law, as you know, which will change the dynamics a little bit, I believe. The answer to your question is I will probably recommend veto, but the reason it is only probably, and you should still not worry, is this: If we don't veto, and an appropriation is passed that exceeds the cap, there is an automatic sequester—that is, cut which brings the appropriation back down to the agreed level. So you've got two ways to control spending now. One of them is the veto and the other is, if you don't veto, an automatic sequester which is already in law, that

doesn't require any additional action. In fact, we have already used it once—I will say by accident, but it was used at the end of last session. The Congress accidentally—it was really a drafting error—appropriated $400 some-odd million more than it meant to in foreign affairs and triggered an accidental sequester. But under the new law, that happens.

By the way, our budget proposal is to undo that and fix it.

Senator BROWN. I thank you, and I yield back. Let me just observe, though, that the entire time Gramm-Rudman was in effect, the targets were never once met—at least, my impression is that—and that each year Congress simply amended the law. I guess the real question here is if Congress amends the law to change the targets, will you veto it or not?

Mr. DARMAN. I would recommend that. I believe it would be a very, very serious mistake to get away from the fiscal discipline that we have built in here. So the answer to your question is yes. I think it would be counterproductive in a host of ways.

Senator BROWN. Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Brown.

Senator Wirth.

Senator WIRTH. Thank you very much, Mr. Chairman.

Mr. Darman, thank you for being here. I must say I'd like to give you some positive items on this budget—I appreciate the honesty of the numbers. It seems to me we have moved away from a lot of the phony economics that have characterized a number of budgets in the past—yours and ours. I thought this is a pretty honest effort in the way you are operating within the rules. I think we all seem to have a new set of rules that maybe are going to be helpful.

I also appreciate the increases in research and development in the budget. I think that there is a great appetite for R&D up here, and would just suggest that as you are developing this and future budgets to keep in mind the great support for that on Capitol Hill and increasing concerns about the competitiveness of this country, about how we have kept up in our university communities with the demands placed thereon. I think there is a start on that, and I hope we see more of that in the future.

I would also reflect on Senator Simon's comments on education and yours on focusing on the whole childhood package, which I think is very important and again a direction in which we ought to be moving ourselves.

Having said that, I wanted to switch to a different set of issues that we haven't talked about this morning, relating to energy. Obviously, Americans are deeply concerned about what is going on in the Persian Gulf, and should be—we have 500,000-plus young men and women in that area—and clearly, one of the reasons we are there, one of a number of articulated reasons, is our concern about oil, and this at a time when we are increasingly dependent upon imported oil and in which the United States' efficient use of energy has, I think from most data, declined in the last couple of years.

Obviously, in the last few months there was nothing the President could do about intervening on energy quickly, but it would appear that among the positive things that might come out of the Persian Gulf might well be an overall energy policy.

I know that the administration is working on this. I understand the President will be announcing the administration's energy objectives sometime within the next couple of weeks.

There has been a good deal of discussion at staff levels, reflected in press accounts, about the competition between the Department of Energy and the White House over a conservation strategy. There are many of us who believe that one of the most important things for the United States to recommit ourselves to is a conservation strategy, and yet the budget as I read it—I don't know if this is the full product and includes all of the elements of the administration's energy policy—has very significant conservation cuts and would appear to again reflect an old approach to energy which is to suggest that we can just produce ourselves out of the problem.

It seems to me that we have to think a lot smarter in the area of energy. I think the American public is expecting that of us and expecting us to focus on this enormous problem. People are very aware of energy once again because of the Persian Gulf.

That is more a statement than a question. I thought this might be an opportunity for you, if you would, to describe what you think the administration's objectives are going to be in this area with special reference to conservation.

Mr. DARMAN. Thank you, Senator Wirth. Thank you very much for the kind comments.

With respect to the energy strategy, I'd beg, if I could, to defer to Secretary Watkins, and as you know, he will be presenting the President's energy strategy on I believe the 19th, which is only 2 weeks from today. I feel I couldn't possibly do it justice, and out of fairness to the tremendous amount of effort he has gone through on this, I ought to let him attempt to do that.

But I could express one narrower parochial interest that is reflected in the budget. In Part II on page 51, you will see that within the R&D budget, we propose a substantial increase in a host of energy-related R&D areas, and I would think that you would agree with quite a number of these. At least from my standpoint, I believe it is one important area of direct investment on the Federal Government's part without crossing the line into industrial policy.

Some of these investments can be rather small, but with tremendous long-term payoff. For example, highspeed rail or mag lev investments, I think ultimately have the potential to save an awful lot of oil consumption, both air and ground. I think that accelerating the development of battery technology so that you can have electric-powered cars is a sound thing to do for a host of reasons, environmental as well as oil import reasons, and we try to fund those. They don't show up as big dollars. Even though we've got a 34 percent increase in energy-related R&D, it still isn't big, big dollars, but these are dollars with very high potential payoffs. So I think we are perhaps in some agreement with respect to the R&D and conservation.

Senator WIRTH. I understand what you are suggesting there. I would also just point out that the conservation budget I think has a cut of about one-third in it off of last year, which I think is just the opposite direction from which we ought to be going; that renewables and conservation research is a total of only 3 percent of the Department of Energy's budget, and that represents, as you

know, a whole school of thinking I think contrary to much of what I have heard stated that this administration is going to do.

I hope that these numbers are incorrect, and I look forward to Secretary Watkins' presentation on the 19th.

The red light is on, and I know we are adhering to that. Senator Lautenberg I always have enormous respect for, so Mr. Chairman, I would yield my remaining time under the red light.

Chairman SASSER. Thank you very much, Senator Wirth, and we appreciate you yielding that time.

Senator Gramm.

Senator GRAMM. Mr. Chairman, given the expression of concern about time, and given the concern about Mr. Darman's long answers, I will minimize the number of questions that I ask.

Mr. Chairman, I'd like to first congratulate Mr. Darman for giving us what I think is a very interesting budget proposal. I think many people thought, having worked out a summit agreement and then a budget that was a derivative of that, that this was going to be pretty much a budget that was defined before it ever came, that it was going to be a dull budget year in terms of decisions made by the Congress, and that the document that was going to be submitted was almost totally predictable.

I think Mr. Darman proved once again that he is capable of doing the unpredictable because, quite frankly from my point of view, this is the most interesting budget that has been submitted by a President since 1981. And it is an interesting budget because it does something that every budget in the United States does except the Federal Government's budget, and that is it makes choices.

In fact, under the spending caps or residual of the summit agreement, much damned at the time, but I predict before this cycle is over that we will learn to love some of the elements of the summit agreement that were preserved even after that agreement collapsed.

For the first time in my 13 years in Congress, now with caps set in place, with the division of three spending categories, for the first time we really are going to be setting priorities, and quite frankly, I think Mr. Darman and the President through their budget have been pretty bold in setting out priorities, and I think they are going to force us to choose between the emerging needs of the 1990's, whether we agree with their definition or not, and the old, stale, rotten status quo that dominates congressional spending.

Certainly there are revolutionary ideas embodied in this budget. The idea of not subsidizing people who make $125,000 or more a year is a revolutionary idea. After all, they vote, too.

But Mr. Darman, I think it is an excellent proposal; it is one that I support, and I think quite frankly it begins to force the kinds of choices that have got to be made.

I'd like to pose my question as it relates to this discussion of sacrifice. I never cease to be amazed at what an appetite we in Congress have for somebody else to sacrifice. Normally, when this committee talks about sacrifice, the sacrifice, or sacrificial lamb in this case, is the poor taxpayer. Would it not be possible under this budget, under the rules that are set out in the budget, for us to

simply reduce spending as a way to compensate for the cost of Desert Storm?

Mr. DARMAN. Yes, it would be possible under the budget agreement.

Senator GRAMM. Well, Mr. Chairman, I submit that first of all, rather than complaining about foreign participation and since foreigners don't vote in Texas, they can never do enough. But I think rather than complaining about what they are doing, we ought to rejoice in the fact that we have had tremendous leadership. I think quite frankly if you could take us out of this context where we want to blame foreigners for all the world's problems and not ourselves, the truth is it is amazing how much foreigners have already provided, and I think we ought to do everything we can to maximize the amount they are providing.

And quite frankly, I am encouraged by the leadership we have gotten by the President. I am hopeful we are going to be successful. I certainly am not going to support using this conflict and the cloak of sacrifice as a reason to raise taxes. I think it would be very harmful, given the state of the economy; I don't think it is justified, and I would guess that it would make our economic problems more difficult.

Let me conclude in the remaining time I have in just making one additional compliment to Mr. Darman and to the President.

I think the proposal that has been made, some $75 billion worth of expenditures on research, science, and technology in the future is a very important proposal. In the past, we have always been for these things, and we have never gotten around to funding them, saying that taxes weren't high enough or there were other impediments. I think what your budget has shown us is that if you are willing to set priorities, you can invest in the future. And my guess is that we are going to be forced to choose between investing in the next election and investing in the next generation. I'm not sure what the final choice will be, knowing the strength of the next election. I am concerned that it may not be the one that you have proposed, but I think having the debate is very beneficial.

I would submit, Mr. Chairman, that in a year that should have been basically a year with no interest in the budget, that we have within our power, given the budget constraints we face, the ability to have a real, full-blown debate on the priorities, and I look forward to it.

Thank you.

Chairman SASSER. Thank you, Senator Gramm.

Senator Hollings has been waiting patiently all morning.

Senator Hollings.

Senator HOLLINGS. Thank you very, very much, Mr. Chairman, and thank you, Mr. Darman.

I was noting last night your appearance last night on CNN with Bernard Shaw, and as I understood it, Mr. Shaw asked you about reducing taxes, cutting the Social Security payroll taxes. As I understood it, your answer was you did not support it because if we did that, we wouldn't have the money then available in the Social Security Trust Fund when the future generations' payments became due; is that right?

Mr. DARMAN. That was part of the answer, Senator. I thought I also said that I was concerned about what would happen in the legislative process and that it wasn't clear to me that the popular idea going in would look quite so good on the way out because there are a lot of additional questions.

Senator HOLLINGS. But really the money would not be there, obviously if you cut the trust funds; is that right?

Mr. DARMAN. Well, as I understand Senator Moynihan's proposal, with which a number of you are also associated—I know you are and Senator Symms and others are—it would actually raise taxes in the future.

Senator HOLLINGS. Let's not get into that. Let's just get into the proposal and the question that was asked, which was would you cut the social security taxes, and your answer was to the effect that that would not be a good idea because then the money wouldn't be there for the payment to future generations; isn't that right?

Mr. DARMAN. That's correct.

Senator HOLLINGS. And yet when he asked you about the deficit for the year 1991, your answer was $318 billion; isn't that correct?

Mr. DARMAN. That's correct.

Senator HOLLINGS. So you have already used the Social Security Trust Fund to the tune of $60 billion for the year 1991. Do you know that the law says you can't use those surplus social security revenues in estimating that deficit?

Mr. DARMAN. Yes; we present the budget in both ways in accordance with the law——

Senator HOLLINGS. You present it all over the lot, and there is no question about that. But the law says you can't use the social security surpluses in calculating the deficit, but you are using it already.

Mr. DARMAN. No——

Senator HOLLINGS. Three hundred and eighteen billion was your answer, and the only way to get down to $318 billion is by using the social security surpluses in your calculation. Again, this morning I noticed the headline with respect to the plane crash out on the west coast. In addition to controller error there was obviously a lack of modernization of the equipment, the removal of obstructions, the communications were not up-to-date. We've got the highest and the finest technology out there in Desert Storm—thank goodness—but not at our airports because you have been using the airports trust fund for surpluses to reduce your deficit. Doesn't that make you feel bad? [Laughter.] I don't think it is funny at all. I have been fighting it—as chairman of the authorizing committee, I have been begging for a proposal to update the facilities at these airports, and now we've got 34 passengers killed, and you are still using the money from all the trust funds for your deficit.

Mr. DARMAN. Senator, there was a major increase that we proposed and that was to some degree funded last year for the national air space plan, and we continue in this budget to fund an increase in FAA—$2.7 billion to continue to fund the modernization of that system. That is one of the things we have said merits increased investment, and we put increased investment in it, and in that respect, since I have been at OMB, there has been a change

from the prior practice, and we have said explicitly that we are willing to spend down that trust fund.

Senator HOLLINGS. Time is limited. Let me get to the budget that you have submitted. We had staff factor it out here on the Budget Committee last night, and over the 5-year period, taking all of your figures as they are at the present time, in 5 years, the Bush budget adds $1.26 billion to the debt, for an average of about $250 million per year, which brings me to that first chart—we ought to turn it upside-down. Rather than the deficit as a percentage of GNP, what about interest costs as a percent of the budget itself? Do you know at the present time that interest costs are already 25 percent of our budget for absolutely nothing, and under your projections here, by 1996, interest will be 30 percent—it will be $377 billion. So we're just going up, up and away with, yes, cut spending, says Senator Gramm—how about cutting this spending that buys nothing—the biggest waste, fraud and abuse in this budget is interest costs; they go up, up and away. And we have put on this charade about a wonderful appearance. I really like you more than this other crowd does. I hear all these compliments and everything else, but I admire your capabilities, I really do. But I think you and I ought to cut out this charade and really get down to paying the bill.

When are you going to pay the bill for war, for health costs, for the deficits? To really break it down, you're not headed in the right direction. You give us this percent of GNP, and, Dick, you know differently.

Mr. DARMAN. Well, Senator, I agree with you about the interest costs. You are correctly including both the interest on the outstanding debt owned by the public and the interest that we pay to ourselves, which is a bookkeeping entry but isn't really a cash interest payment when you make your calculation. I think that that's an important point.

But then if we get to the question, what are we going to do to cut the growth of debt below what we propose? There are only two answers. We've got to increase revenues or we have got to cut spending more than we propose.

And increasing revenues can be done by increasing the rate of growth in the economy which is what we would prefer, or by a specific tax increase proposal. We propose to cut spending in entitlement programs and other mandatory programs only $47 billion over 5 years. I think someone could have said, why are you only doing that; why aren't you doing a whole lot more than that?

But the initial reaction, to judge by my newspaper, of a large number of people in Congress has been to question why we are proposing any additional spending reduction at all.

So, I think we have struck a reasonable balance. I'm somewhat mindful of what I think the political system can do. We had a tough enough time getting last year's agreement done. I must confess to being disappointed that we couldn't do more last year.

We pressed the outer limits of what the political system seemed to be willing to do and at that, while it was a record in terms of its contribution to deficit reduction, it is still by some measures modest.

Chairman SASSER. Well, thank you, Mr. Director.

Senator Grassley.

Senator GRASSLEY. Mr. Darman, I believe that the administration is doing a pretty good job on soliciting funds from other countries, as well as accounting for their coming in. Prior to my feeling along that line, some of us introduced legislation in this area. There still may be a need for legislation.

But, on the other hand, I think I would like to have you, if you could, follow-up on what you told Senator Sasser and not really answer now, but if you could just put some of those figures down on paper, kind of like an accounting document that could be updated maybe once a month or something. That's what our legislation called for. If it could be this simple. You have got $41.7 billion promised for this quarter; you had $10 billion promised for last year—that is $51.7 billion. So much was promised by a country. So much was promised in-kind. So much was promised in cash.

And then just kind of give us, if you can, in a day or two, where you are at that point, country X what they promised in-kind, and in cash and then what has been delivered in-kind and in cash. Then maybe you could just update that once a month.

If you could do that I would sure appreciate it. I think that that would put down so that we would all be comparing apples with apples, because you know you hear so many different figures, and you read about them in the newspaper and it's never comparing apples and oranges.

So I hope you can do that for us. I just think that's a natural follow-up of what you had already told Senator Sasser. Would you do that, please?

Mr. DARMAN. Yes; Senator Grassley, I would be happy to do that.

Senator GRASSLEY. OK.

And then update it. You know, I don't want to be making it overburdensome but it doesn't seem like if you would update that once a month that that would be difficult.

Mr. DARMAN. No, no, I think it would be useful. I hope that we can keep this issue of funding the war costs on the relatively bipartisan basis it has been on so far and I think to the extent that we share information it will help do that.

Senator GRASSLEY. OK, thank you, very much.

On another point, you might find it surprising that I would be willing to look at your proposal to put a lid on farm subsidies. I have voted twice in the last 10 years for proposals, maybe not similar to yours but at least trying to get to the same end, because I believe in targeting farm programs to a greater extent. I don't know enough about the details of yours to say that I could just support it the way that you proposed it. But I would surely like to work with you on that. And I am, for the first time in my Senate career, serving on the Agricultural Authorization Committee this time, so I would like to work with you on it.

Could I also go along that same line then and suggest to you that while you are identifying hidden liabilities and also another category that you have, high-risk areas of vulnerability to fraud, waste and abuse—and those are your words—I would like to have OMB, in addition to what you have already identified as Maritime Administration's inadequate controls over the disbursement of Federal funds—such that there is operating differential subsidy and you have labeled that as one of your high-risk areas—I think that you

have ignored a far bigger wasteful hidden back-door maritime subsidy and that we call, cargo preference.

So I guess I would like to have you look at suggesting that as an area for reform as well. Maybe there is a legitimacy for subsidy. I wouldn't take the position that there is not a legitimacy for subsidy, but it is very much a hidden subsidy. I would think, at the very least, that you would want to get that out into the open so that we could have it appropriated from year-to-year like we do farm subsidies, as an example.

Along this line, I sent you, this past August, a copy of OMB's 1982 study which concluded that the objectives of the Maritime subsidies have not yet been met and that there is little justification for continuing these studies. That is from your own agency.

I also sent you, last year sometime—and I am not going to beat you up on this, I just want you to take a look at it—a CBO study that Senator Domenici and I requested last year to identify the hidden costs of cargo preference.

In that study, CBO found that cargo preference and ODS is costing U.S. taxpayers $1 billion a year and if you would divide that by the commercial seafarers' jobs that are supported by cargo preference into the overall cost of cargo preference you will find that we are subsidizing each seafaring billet to the tune of over $400,000 per job.

So I guess, you know, this is a monopoly. There is some legitimacy to it. We ought to get it out in the open and we then maybe might decide that it doesn't have to be as costly as it is.

So I guess while you have done a good job of looking at one, the amount of money you would save by the one you suggest looking, is not as big as the one that you suggested.

Then finally, before you comment, I just simply suggest to you that I will submit in writing things that I brought up a year ago now on how the Defense Department is making progress on meeting their defense management review things. It has been before us for 2 years. We have not, you know, we have been dissuaded to some extent by a war that is going on, but there is 55,000 employees over there and somebody has still got to be working on defense management review. I am not very satisfied that we are making very much progress on that but I will let you submit those responses in writing.

Mr. DARMAN. Well, thank you, very much, Senator Grassley.

Chairman SASSER. I just want to follow-on very quickly to something that Senator Grassley said. I think it would be very helpful if we are going to maintain a bipartisan approach to supporting the expenses of the war in the Persian Gulf that we get an accounting from the Administration.

Now, we requested the Secretary of Defense and the Secretary of State to send someone before the Budget Committee in mid-January to give us an accounting. We were refused. The Secretary of State and the Secretary of Defense refused to send a representative of their departments to come before the Budget Committee and give us an accounting of what we were receiving.

Now, as a result of that there are discrepancies between what you have stated this morning, Mr. Darman, we have received by way of assistance in financing the war, and the other figures we

are getting from CBO sources—which to some extent are based on DOD informal sources—as I understand it.

Now, I will just give you a quick run-down of what I'm talking about. You are indicating, as I understood you this morning, that the Japanese for calendar year 1990 had pledged $1.7 billion and had paid in slightly over $1 billion.

Now, according to CBO's estimates they have only paid in $428 million in cash and $206 million in in-kind contributions and had pledged $2 billion.

You were telling us this morning—and I am not challenging your figures, I'm just simply stating that this is what gets us into difficulty here—you were stating, as I understood it, that $11.1 billion had been pledged and that we had received maybe $9.7 billion—rounding it off—as of for calendar year 1990.

According to CBO we have received for calendar year 1990 in cash $4.6 billion—rounding it off—and in in-kind contributions $1.3 billion for a total of $5.8 billion.

So you see there is a substantial discrepancy between what we're getting from CBO and what we're getting from OMB. So if you could follow closely Senator Grassley's, I think, very helpful suggestion, I think it would go a long way towards allaying any disputes about who is doing what and what needs to be done.

A quick answer because I need to turn to Senator Robb.

Mr. DARMAN. Two quick points. One, $11.1 billion is the total expenditures through December 31st, including in-kind. And $9.74 billion were the total foreign commitments, not the amount actually received.

The amount actually received that I tried to say, was $5.32 billion in cash, $1.26 billion in in-kind for a total of $6.58 billion. But a second quick point and I will be quiet.

We have improved, I think, within the executive branch, the system for coming up with reliable numbers here, or at least as reliable as the data allows. I hope you will find we will be able to speak with one voice, and we will be able to be responsive in the way that you suggest.

Chairman SASSER. Thank you.

February 22, 1991

DESERT SHIELD: CY 1990 FOREIGN COMMITMENTS TO THE U.S. 1/

(Millions of Dollars)

	Commitments	Receipts			Future Receipts
		Cash 2/	In-kind	Total	
GCC STATES	6,845	4,177	971	5,148	1,697
SAUDI ARABIA	3,339	807	854	1,661	1,678 3/
KUWAIT	2,506	2,500	6	2,506	
UAE	1,000	870	111	981	19 3/
GERMANY	1,072	272	531	803	269 4/
JAPAN	1,740 5/	866	457	1,323	417 4/
KOREA	80 6/	50	21	71	9 4/
OTHERS	3		3	3	
TOTAL	9,740	5,365	1,983	7,348	2,392

U.S. Share of CY 1990 Incremental Costs	1,354

Total CY 1990 Incremental Costs	11,094

1/ Data compiled by OMB. Sources of data: Commitments for August – December 31 — Defense, State, Treasury; Cash received--Treasury; Receipts and value of in-kind assistance — Defense; Total cost for August – December 31 — Defense.

2/ $1 billion has been released from the Defense Cooperation Account to Defense in accordance with the FY '91 Appropriations Act.

3/ Cash reimbursement from Saudi Arabia and UAE awaiting bill from Defense. Saudi reimbursement includes enroute transportation through December for the second deployment and in-theater expenses for food, building materials, fuel, and support.

4/ In-kind assistance from Germany, Japan, and Korea. Orders made and receipt of goods expected soon.

5/ Japan pledged $260 million to other coalition forces for total contributions of $2 billion.

6/ Korea pledged $15 million to other coalition forces for total contributions of $95 million.

Chairman SASSER. Senator Robb.

Senator ROBB. Thank you, Mr. Chairman.

As I have observed and I will observe again, I think the most thankless position, at least in the United States Senate, is being chairman of the Budget Committee. I suspect the most thankless position in the executive branch is being the Director of the Office of Management and Budget. I would rest my case based simply on the preliminary questions that were essentially unreconcilable that were directed to you this morning.

Let me, if I may, observe that to the Director, Mr. Darman, that I do appreciate the fact that I think this budget moves in the right direction. I will be, perhaps, less effusive in my praise than a couple of my colleagues on the other side of this particular horseshoe because some of the things for which you were praised, of course, are required by the budget agreement and other constraints, but nonetheless move in the right direction.

Still, I think it is more honest. I think you have attempted to make some choices and put something on the table. As you know, that is something that I have been suggesting in the past: that if you are going to ask us to do something that you need to put something on the table first. I think that with the exception of resolving the question of the $15 to $20 billion of turn-back programs that will be negotiated in due course, that there are choices in this one.

I appreciate that and the way that the budget is presented is more honest.

Let me say that I don't pretend to have read the 2,000-plus pages. I doubt that I will ever get around to reading all of those. I haven't fully digested your summary or some of the things that I have read in the last 2 or 3 days that have given some insights into what this budget is all about. I hope to be more knowledgeable in due course. So I am going to be very general in the questions and I really only have two and they are almost broad philosophical questions rather than asking you about a particular dollar amount that goes up or down by a particular percentage. Again, I recognize, having put budgets together that the questions can't all be reconciled in the same forum.

I am concerned about the question that Senator Simon asked about what we are doing with respect to the funding of Desert Storm. I would just ask, as a question, whether or not you gave any consideration—I heard your explanation to the chairman—about some of the actual costs and how they were arrived at and the contribution of our allies and certainly I'm familiar with that. I would join others in commending the executive branch on at least achieving that degree of participation. I think that does exceed what appeared to be the apparent level of contribution early on.

There is nonetheless a residual amount that the United States is going to have to pick up the tab for over and above actually fighting the lion's share of this particular war. It seems to me that there is a basic inequity in asking our troops at this point, who are stationed in the Gulf, to bear all of the burden when, in a contemporaneous way, that we are not willing to bear some of the burden here.

I heard all of the statements that were made and they are fairly predictable about we don't want to have a war tax, we don't want

to increase taxes at all. I thought that Senator Gramm and others invited a possible approach in terms of reductions in spending if we are not going to increase taxes. But something that allows us to share part of that burden that is being disproportionately borne by the troops overseas.

Just a philosophical comment, if you will, on why we don't attempt to put some sort of a plug number as we have to do for entitlement programs and others in there and distribute that burden either through some additional reductions in spending or some increases in revenues, which I realize they are both very unpopular politically, but nonetheless, it seems to me to have a value.

Let me just ask a second question because it is related and then I won't have any more questions at this time. In putting this particular budget together you were, of course, bound by the constraints of the budget summit agreement that came out last year. The one feature, at least in terms of process, that I did like was establishing the cap under which you operate this time. I think it does allow for more honesty in the presentation of some of the other areas.

But I think, as Senator Simms indicated, the cap is a ceiling and is not a floor. Was any consideration given on your part, in putting the budget together, of actually budgeting less in any substantial amount, less than is allowed under the cap in any of the three categories, so that we could achieve some additional meaningful deficit reduction over and above that which was required by that particular budget agreement?

So, two fairly broad philosophical questions at this point.

Mr. DARMAN. Thank you, very much, Senator Robb.

On the first question, we do have a plug in there of $15 billion. I don't know that that is the right plug for all the reasons I have already said. And you could get in a near metaphysical debate as to what that $15 billion is financed with.

One way of looking at it is, since I have said it is already in the deficit numbers, that it is being financed with debt. But another way of looking at it is since we have also proposed substantial spending reductions, above and beyond what the budget agreement required, that it is being financed and then some by additional spending reductions.

The one way in which it is not being financed is with additional tax increases, and we do not favor that.

Senator ROBB. Let me just ask for a clarification.

I am aware of the $15 billion plug that you discussed earlier but as I interpret your remarks and I have not looked back to see where it comes in the budget, that's a plug number that simply acknowledges a plug amount in terms of the deficit but doesn't really account for the way that it is going to be spent down. Is that——

Mr. DARMAN. That's correct.

Senator ROBB. That's the philosophical point I'm getting at right now. I'm aware of the $15 billion plug for potential liability in either the first quarter or the whole budget.

Mr. DARMAN. We're going to have a more detailed proposal that comes with the defense supplemental I hope in the third week of February, 2 weeks from now, that will address this in very considerable detail, through March 31.

What we cannot do at this stage with any degree of validity or reliability is look beyond that point.

Senator ROBB. The only question though, will there be any proposal for additional reductions in current proposed spending that are a result of that supplemental? That's the only question I'm getting at right now.

Mr. DARMAN. What I'm trying to say is that since we've already put the funding for the supplemental into our deficit forecast, that $15 billion is already in there. We have also put additional spending reductions into our budget above and beyond what the budget agreement calls for. So you could say that those additional spending reductions are helping to offset the adverse deficit effect of the additional $15 billion.

That is not the way that they were conceived. They were conceived as having merit in their own right. And if you don't conceive it that way you would have to say we are financing Desert Shield with debt. If you say that, the only point I would make is one that I made earlier—your available alternatives are debt versus taxes if you don't have additional spending reductions. Taxes don't seem appropriate in the current economic circumstance. The one thing you can say if you believe it is being financed with debt is that at least this is an investment that is going to make a better world for the future and the people who are the beneficiaries of that will end up paying.

Senator ROBB. Are you going to get the second point in terms of any consideration of proposing spending below the cap levels?

Mr. DARMAN. Yes; on a 5 year basis we are $47 billion below the base-line in mandatory programs. In the discretionary caps, we are at the outlay limits in the caps but we are below the budget authority limits—only marginally below, a few billion dollars below.

The problem that you have in trying to go a lot below the caps—and by the way, I may say the Republicans, some in the Senate and especially in the House side, were very, very anxious to see us go well below the budget agreement caps—the practical problem you have—this is a technical point, unfortunately, but it is real—is that there is already a lot of spending built-in for 1992. So take domestic discretionary—the cap is about $211 billion. But if we funded zero in new spending this year, the spill-over from the prior years would consume about $97 billion of that $211 billion cap. So you have only $114 billion in new outlays for domestic discretionary for all the functions of government.

When you sit down with a group of people who start out saying, let's get well below the caps, and you spend the time working through it, they have trouble coming up with numbers themselves.

At any rate, to answer your question, after a lot of back and forth, we came in at the cap level in outlays and the budget authority came in below the cap level.

Senator Robb, one last thing, I will be quick.

There was a second consideration, which is political which I would raise and it is this. Because of what is happening on the defense side, we will be at the defense cap and we will also have the Desert Shield supplemental above it.

I felt that if we came in below the cap on the domestic side it might be viewed as violating the spirit, not the letter, but the spirit

of the budget agreement since we would be, in effect, going over on defense and under on domestic discretionary.

I thought for that reason as well to try and keep the partisanship down on the defense side it would probably be wiser to come in at the cap levels.

Chairman SASSER. Thank you, Senator Robb. Senator Lott.

Senator LOTT. Thank you, Mr. Chairman.

I would like to say it is a pleasure to be on this committee, even though I got a note from Senator Exon that said, I see you are on the Ethics Committee and now you are on the Budget Committee, somebody really doesn't like you, do they? [Laughter.]

Senator LOTT. But in spite of that, I am delighted to be here and I would like to say, Mr. Director, you always do an excellent job and I appreciate that, in the way you present it whether we agree with you or not.

And also I have to acknowledge, as we all do, that your numbers here are being driven or being affected by the budget agreement of last year whether we like that or not. And I did not like it. I made that very clear.

But I do think that you need to be committed and while there are going to be changes made this is a more realistic budget than we have had for some time, and even one of the local newspapers has described it as mainly honest which is a high compliment when you consider the source.

It bothers me that in looking at most of the categories, most all of them are going up except defense and that one is sliding down, when you look at the discretionary accounts.

I guess the first question I would have for you, in the charts that you showed us you made a very accurate point of the fact that the mandatory programs are spiraling up. But I heard very little that you were proposing to begin to get better control on those mandatory increases.

How do you respond to that and what are we going to do about that tremendous escalation, even though they are programs that we all like? Now, that we have got social security off of budget, maybe we can deal with the need to control the rate of increase.

Mr. DARMAN. Thank you, Senator Lott. I express my sympathies to you for the misfortune not of joining the Budget Committee but of having to deal with me. I know how difficult a burden that could be, and I appreciate it.

Senator LOTT. I'm sure it will be better than in the past. That was supposed to be funny. [Laughter.]

Mr. DARMAN. With respect to your substantive question, the mandatory programs where we propose to restrain the growth are listed in the introduction that I hope is before you at Table 2-9. It is a three-page table. It has a summary listing of the particular measures we propose. We propose $47 billion worth of savings, that is reductions in the rate of growth in the mandatory programs on that list.

We do not propose savings from social security. But we do propose savings in a full range of other mandatory programs. Could we do more? Yes; we could certainly write more on paper. And should we do more? My personal opinion is that we should do substantially more.

But I tried to adjust, to some extent, to the realities as they were revealed in the budget negotiations last year. And what I presented is at least within the range that I think can get some consideration and have some chance of passage.

Right now, I might say that there are quite a number of people who have been negative about some of these proposed savings, but I think that as they look at them and as they see where they want to have some spending ideas and they know they are in a world of pay-as-you-go, they may decide that they like some of these when they look at them a second time.

Senator LOTT. I do think that a lot of the priorities or a lot of the areas where the President has proposed increases is good. You have talked about research and development. You have talked about some programs that benefit children. You are talking about some changes or increases in NASA, programs of that nature, and that's good.

I am interested in some of the changes you proposed. I would like for you to elaborate just a little bit on the student aid question. You know, the big emphasis is that we need to make more direct assistance available through grants to the needy and that is fine, I understand that. But I also worry about those lower middle income people who really do get squeezed and they are not eligible for the grants and they are not rich enough to educate their children without some assistance. You mention that what you are talking about is some more grants, shifting some of the loans that have been going to the lower end, shifting those up to the middle income.

The question is, exactly how are you going to do that and is there a cost involved? And don't you feel like we ought to keep some assistance for that middle income person?

Mr. DARMAN. Yes, I do feel we should keep some assistance for the middle income person. What we are proposing to do is to switch the grant portion downward so that if you think of how much a student has to pay to go to college or graduate school, whatever that amount is, some portion is paid for by grant, some by loan and some by other sources.

What we are saying is for the poorer people, let's increase the percentage that is grant. And for people who are near poor, or middle income, we will decrease the grant size a little bit and increase the loan by at least enough to make up the difference, so that the person can still have the tuition covered. But the person from a little bit higher income level is taking a little more of the burden in loan; and the lower income person is getting a little bit more of the benefit in direct grant.

We can show you the exact formula by which we propose to do it, according to income level.

Senator LOTT. There are those, particularly in the other body, that propose, I think, to do away completely with loans and go just with grants. You would not be for that at all?

Mr. DARMAN. No, that's a different thing. What they have been talking about, I believe, has been federalizing the loan program, taking the private intermediaries out of the action altogether and making it a direct Federal loan program.

My personal view is that that will not accomplish the purposes they have in mind in terms of increasing efficiency or savings.

There is no evidence, none, that the Federal Government can administer that kind of enormous loan program more efficiently or effectively than the current intermediaries.

Senator LOTT. I agree with you and I just wanted to get that on the record.

Two more quick points, if I could. On your supplementals, every administration, every director comes up here at the beginning of Congress and asks for a supplemental or, in your case, two supplementals. I presume you are going to ask perhaps for one, as the needs might arise for the Desert Storm but then you are going to ask for another supplemental.

And every time you come up here saying this is what we need and this is all we need. And, of course, we, in Congress, when we get through doctoring it, you get twice what you say you need. My question is, why do you need one at all? Don't come up here and ask for a supplemental unless it is an absolute dire emergency because if you do we are going to add to the deficit by piling on.

Mr. DARMAN. Well, I agree with your general point and perspective. Let me explain what we have done and why.

We have tried to limit the supplemental requests to something very close to the emergency standard. Desert Shield, clearly merits a supplemental. We have a Supreme Court decision that we have not previously planned for that came down called the Zebley decision which requires an enormous increase in reviewing all of the disability cases administered by the Social Security Administration from 1972 to the present. It is a multi-billion dollar additional expenditure and it has a big administrative burden. It is under court order and it has to be paid for. We don't have any choice. The judiciary has come in for a supplemental and we have no choice. We are bound to submit that because that is the way the procedure works, as with the legislative branch.

And the last one, the one that is the increase that we proposed on our own, is unemployment insurance, for the State administrative costs. Because we are in a recession, the State administrative burden has—I think it was Senator Sasser who said at the outset—increased, and we have proposed $100 million supplemental to take care of that. It is money that I think does have to be expended and the Congress is going to appropriate it. The States asked for $121 million and we are proposing $100 million.

Chairman SASSER. Thank you, Senator Lott.

Senator Exon.

Senator EXON. Mr. Chairman, thank you very much.

Mr. Chairman, let me start out on a very positive note. You and I have had our differences over the budget from time to time, but let me tell you that I do not agree with all parts of this budget, nor do I agree with the priorities set in certain areas, and we will be working those out here under the process.

I happen to feel that over the last 10 years, at least this is an honest attempt and the most honest budget presentation that we have ever had from the Administration, and so I congratulate you on that.

I notice some very positive things that I have been very much interested in, I think for the first time in the last 10 years the administration has recognized that we are going to continue

AMTRAK and fund it at the level I think it should be funded. But never before, generally, Amtrak has been struck.

The essential air service program has been funded to what I think is somewhere near a reasonable level.

From what I know of your agricultural proposal, coming from an agricultural State, I think that is something we can live with out there, and I think from what I know of it, it looks like its approach is not only fair, but workable.

I have a question with regards to physician reimbursements. I do not know whether or not you are aware of it, but Nebraska and several other States tried to have an arrangement where, under medicare, the States, working in conjunction with their medical associations could, set the difference in payment between small communities and large communities.

In other words, as you know, there is a difference between specific operations that are performed in a city in Nebraska like Omaha and a city named Ravenna that you have never heard of. Ravenna is a typical small community. I think it would be well if we could make that a policy, basically, with whatever the allocation is between the individual States. I think this sets in with this new federalism or whatever you want to call it, to let the States make those decisions.

In Nebraska, we have a situation where we had the medical profession agree to equalizing that out, but we had trouble getting it through the bureaucracy. I do not know whether you know the answer to whether that is included or not, but I want to plant that seed with you.

I noticed with great interest the chart that you had up. I must say, Mr. Darman, that I have been looking at charts like that for the last 12 years on the Budget Committee, and never have I seen a chart that shows them going up and up and up. They are always going down and down and down, but it never seemed to work out that way.

I do want to ask you a question, something about how much stock we can place in that, regardless of—I thought you made an interesting point with the trends of the different projecting agencies. You will remember that, a year ago in this room at this time, you and I had a discussion about the projected deficit at that time for 1991, and you had estimated that that deficit for 1991 would be about $120 or $130 billion.

As I take it, your current estimate for the 1991 deficit is about $318 billion. Is that accurate, and am I comparing apples with apples and oranges with oranges?

Mr. DARMAN. They are not quite apples and apples, because the first one did not have deposit insurance in it, and deposit insurance is $106 billion above and beyond what was in last year's. Last year's estimate was made excluding the outlay effects of deposit insurance working capital costs, or putting them at zero, and noting that they had to be worked out with the Congress later as to how they would be scored. We did work it out and we have scored it on budget now, so it is not quite apples and apples.

If your point is that I was wrong, you are right.

Senator EXON. I was not trying to get you to say you were wrong, Dick, because I knew you were wrong at the time, though that is not too important. [Laughter.]

Let me talk about some military programs. As I understand it, the Administration is coming in with a $4.6 billion request for the SDI program once again. As chairman of the committee of jurisdiction over in armed services, I happen to feel that is way too much. That is pretty close to what was asked for SDI last year, and it was reduced back down to something under I think $2.8 or $2.9 billion.

Is there any basic justification for the dramatic increase from $2.8 to $4.6 billion under the President's request?

Mr. DARMAN. Yes; Senator Exon. I think we requested $5.3 billion—I am going from memory—last year, and I think you gave us around $3.5 billion. Maybe it was less. Maybe it was——

Senator EXON. I think it was less than that.

Mr. DARMAN. $3 billion, perhaps, somewhere in that range. We are now requesting $4.6 billion, so what we are requesting is actually less than we were requesting last year and less than we projected to request this year.

A general point: The overall program cost, which you will see for the newly focused reconfigured approach here, is way, way down from what the original SDI concept was. I think you will approve of that shift.

Senator EXON. I have not looked at it.

Mr. DARMAN. Second of all, if you have not seen it already, I think what you will see is that the technologies being used are simpler, more reliable technologies. It is still very high-tech, but the technologies are simpler and more reliable than the original SDI concept was imagining, and to that extent I think you will find you can have more confidence in both the system working and in the cost estimates.

A third point, the overall focus has changed in emphasis to where, in the early stage, it is more for protecting in-theater encounters, rather than intercontinental encounters, and insofar as it moves toward the longer-range ballistic missiles, it does so first by focusing on accidental launches and only at a very much later stage, at what was the original concept.

So, for certainly the intermediate stage, I think you might find that those who have been critics of the level we have asked for might find that this is a different, a more workable and a more sensible approach, especially in the light of what we have seen in the use of the Scuds.

Senator EXON. You mean in the use of the Patriot against the Scud, is that right?

Mr. DARMAN. In the past the Congress did not think the SDI was popular, but the average person thought the SDI was popular, because they have an intuitive sense that civilian populations might be at risk.

War planners assume the other side is rational and would operate on a strictly military strategy. What we see here is the contrary.

Senator EXON. Thank you very much, Mr. Chairman.

Chairman SASSER. Thank you, Senator Exon.

Senator Bond.

Senator BOND. Mr. Chairman, I thank you.

Mr. Director, I want to compliment you on your fortitude, your ability to withstand pain and to stay with us for almost 3 hours. I would congratulate you also on a very realistic and tough budget. You have held the rate of spending to 2.6 percent, even including the recognition of the costs of the savings and loan bailout.

I think your budget recognizes that choices have to be made and I commend you on your willingness to terminate programs and projects, and to put it on a pay-as-you-go basis. I only hope that Congress appreciates the need to make choices.

I would say by way of editorializing here that we now have in town some of my former colleagues of the National Governors Association, and these are the people who in the past have been in the forefront and do bear the major portion of funding of education. Some of my colleagues have talked about why we are not spending more on education.

I think, as you and I have discussed, that one of the reasons there is not going to be more money spent on education was a result of choices made at the last minute in conference committees last year, not subjected to debate on the floor, to include a very significant expansion of medicaid. Medicaid in 1985 was 10 percent of State budgets. Last year, it was up to 14 percent, but with the new expansions it will be 17 percent of State budgets by 1995.

In talking with Governor Ashcroft, the Governor of Missouri, he advised me that, of the new money coming into the State that can be appropriated this year, 85 percent of it is devoted to paying for new congressional mandates. That means only 15 percent can go to fund any programs the State Legislature want to fund, including increases for education.

So, for those people who say we are not spending enough on education, because of a choice that Congress made and imposed on the States, the money is not going to be there for education in Missouri or in many other States. So I hope there will be realization that when we make a major mandate, we are taking away from some things people may regard as priorities. I would hope there would be a reality check in Congress and a recognition that that is what we have done.

Now, speaking as a former governor, I would commend you also on your bold proposal to give States flexibility by turning over as a block grant some of the programs which have been essentially run by the States, but administered under Federal rules, regulations and red tape.

You have indicated that we may only save about a quarter of a billion dollars at the Federal level by getting rid of that overlap, but I assure you that the savings will be many times that at the State level, because if you do honestly turn over the same amount of money which has been given to the States in the past, and you get off of their backs and do not require them to fill out the reports and dance to the tune that a Federal bureaucrat has been playing, they are going to do a lot better job of spending the money.

I would ask you, having been led down that road by the Federal Government in my previous incarnation and seeing the ground cut out from under me, what mechanism do you propose to assure that when the $15 billion is actually received by the States. While we

may fund it this year and next year it's certainly possible that say in the 1994 budget somebody says, well, that $15 billion is a good target, we might just dip into that so we can fund some more of our priority programs. How do you propose that we could give some assurance to the States that they would continue to get that money in the future? Would you propose to set it up as an entitlement?

Mr. DARMAN. Thank you, Senator Bond.

On your point about medicaid, we are sympathetic with the perspective you reflected and we have talked with the governors about it and we do not have any new medicaid mandates in this budget. I know the governors are proposing to change the mandate that was included at the end of last year, and we have told them that we would not oppose that effort. That was never part of the original budget agreement, although I am not sure they will be able to be successful, given the strong feelings, especially on the House side.

On the new block grant program, I think you have to wait and see what programs are actually mutually agreed to be in the package. In our set, there are two mandatory programs, and the rest are discretionary. One of the mandatory programs is already capped, social services Title XX, at $2.8 billion a year for 5 years. And so if it were turned back as part of the pot, obviously that one is easy, because you would find a way to continue the protection for the $2.8 billion as a capped mandatory.

Senator BOND. Is that an entitlement? Title XX is written in law?

Mr. DARMAN. Title XX is what is called a capped mandatory. It is a kind of hybrid. The other big piece that is mandatory on our list is the set of administrative expenses associated with the Federal share—there is a State share, as well—of administering AFDC, medicaid and food stamps. That is an entitlement also, and that grows from around $5.1 billion this year, up to about $8 billion.

What we have told the governors is we would want to find a way to make sure that they were protected against that expected increase. It can be done and invented legislatively, but I think before we go to the question of what is the mechanism, we, governors and the Congress ought to agree on the set of programs. Obviously, Congress is the most important player in this process. When the Congress agrees a mutually agreeable set of programs with the other parties, then we can go to the design question.

Until we know how much is mandatory, how much is discretionary, and which rise and which fall, we do not know exactly what problem we have got.

Senator BOND. Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Bond.

Senator Riegle?

Senator RIEGLE. I want to cover three points quickly. I know you have been at the Chair a long time today. I want to say to you that my own view—and we all have our own—is that the economy I think is in deeper trouble than we are presently acknowledging or even able to maybe measure on a real time basis, and I think the deficit is going to be a good bit higher than we are now anticipating. I hope that is not the case, but I believe it is.

What I want to know is, what if the economy continues to go down possibly beyond what we are now forecasting, and that be-

comes apparent, say, over another quarter. Are you doing any kind of contingency planning as to how we might stimulate the economy or level it out, if in fact it is dropping beyond what we now project?

Mr. DARMAN. I would not like to say this in a way that in any respect created a headline that would be overplaying it. We are doing our jobs, at least as I would understand them, and, yes, of course, we have to look at the possibility that things could be worse and we have to discuss what are available options for dealing with them.

When the issue arose before the Senate of what to do with the enforcement procedures in the Budget Act, for which there is a recessionary trigger to possibly waive them, you all, correctly in our view, voted not to waive them. But we said at the time, and many of you said at the time, that if circumstances change and we had a different view of the economy, that is one issue that would have to be addressed.

Many have talked about the substantive policy changes that would have to be addressed, and we have those under review, of course I appreciate your view, but I would say our forecast is right dead in the middle of outside private economic forecasters at the moment, so we think it has some reasonable chance of being right.

Senator RIEGLE. But getting to the bottom line, then, is any contingency planning being done in a formal way, in the event that the economy drops faster than you are now anticipating? Is there anybody at work on what might be done to break the fall, if in fact it is steeper and faster than it might look today?

Mr. DARMAN. Have the President's Economic Advisers and the Chairman of the Federal Reserve and others talked extensively about these issues? Yes. Have the specific policy options that people have recommended been analyzed? Yes. But are we at this point acting in a manner that would merit a headline that says "Administration Doing Contingency Planning"——

Senator RIEGLE. Forget the headlines. No, I know you are worried about the headlines. I am more worried about whether you are giving it some personal thought and attention and whether you have got some of your smart people working on it, because I think you should have and I am wondering whether you do or not.

Mr. DARMAN. We have on it what we take to be the best people we have got.

Senator RIEGLE. Are you working on contingencies, if things are worse than they now appear?

Mr. DARMAN. Yes, and you will see even in our own budget, in Chapter 3, that it talks specifically about how there is a special risk in the deposit insurance area, with which you are especially familiar, and we took pains to deviate from the previous way of modeling this. In the previous way, we have had standard rules of thumb: if the economy grows so much less, it automatically translates into such and such. Our rules of thumb are different this year, especially in their adjustment for deposit insurance effects, because the financial service sector would be especially vulnerable, if this recession were to continue.

Senator RIEGLE. Now, on that point—and I appreciate you raising it, it is the next thing I wanted to raise—and that is there is no formal proposal as to how to recapitalize the bank insurance fund,

as you know, and I would like to have you come before the Banking Committee and talk with us about that. Would you be prepared to do that sometime in the next 30 days or thereabouts?

Mr. DARMAN. Yes, I would be happy to do so. I would like, of course, to defer to the Secretary of the Treasury, but yes, I would be happy to do so.

As you know, we have made our own estimates of the shortfall in the bank insurance fund for perhaps the first time in a long time. We are at the more pessimistic end of the range. I think the FDIC is not quite as pessimistic as we are about that, and we have built that into our deficit forecasts.

Yes, I would be happy to do so, subject only to deference to the Secretary of the Treasury.

Senator RIEGLE. We want to have you come, because there is a difference of opinion and you are looking at it from a budgetary impact point of view, and we have got to make sure that we do not overrun the fund, so we do need to have you come and talk with us about that. Senator Sasser serves on that committee, as well.

One question with respect to the money, the $100 million, you are asking in supplemental funding for unemployment insurance administrative expenses, and you have touched on that this morning. The data that I have indicates that the Interstate Conference on Employment Securities Agencies is actually estimating a shortfall, not of $120 million, which I think you cited, but something between $150 and maybe $200 million.

We have got a real problem in Michigan right now, and we are very late in responding to some of the unemployment compensation needs. With the fund running a surplus last year of $1.1 billion, can we not get up to the full amount of money that seems to be needed here? I mean that, in a sense, is countercyclical. We certainly want people out there who are in an unemployment situation to be able to be responded to as quickly as we can. So, can you take a look at that and can we not beef that up? I am troubled that we are coming in in the formal request below, even on the low side, the estimate of what is needed.

Mr. DARMAN. Could I respectfully suggest, Senator, that some of the people who do the estimates do so knowing that they are in a bargaining process. I think the governors' inside honest estimate was $121 million. The Labor Department's bargaining position for its dealings with OMB was $140 million. I have not heard anybody above $150 million until this comment.

Senator RIEGLE. How about going to $121 million?

Mr. DARMAN. Well, we think we can justify the $100 million. Obviously, that is subject to appropriation, and if the Appropriations Committee, upon examination, views it differently, they will make that judgment. We are suggesting that $100 million is the right number, and I assume that they will look at the same data as you have and reach their own conclusion, after they get the benefit of our judgment.

Senator RIEGLE. Well, I will just finish, my time is up, by saying, as you know, there are too many people in this country that live from paycheck to paycheck, and you have a fast rise in unemployment and you have a lot of layoffs—you saw the GM announcements today, that is just sort of typical of what is happening.

This is a program where the money is available and I really think we have got to push it through the pipeline and get it out to the people. I do not want people defaulting on their car loans and their house payments.

Mr. DARMAN. We do not disagree, Senator. We are just trying to find what is the right number, and we think it is about $100 million. But $21 million in a $6 trillion economy is not going to be the——

Senator RIEGLE. That is why I would rather have it in, than out. Because if somebody out there is waiting for an unemployment compensation check and is not getting it, it is the biggest single item in the budget.

Thank you.

Chairman SASSER. Thank you, Senator Riegle.

We are hitting the home stretch here, Mr. Director, and just let me make one or two quick comments.

First, I want to congratulate you today in bringing to us a budget in which I think you have honestly tried to estimate the size of the deficit. We are all staggered by the amount of it, $318 billion, but it is better to have that estimate on the front-end, than learn on the back-end just how large it is going to be.

I think this indicates, at least to my mind, one of the futilities of the Gramm-Rudman-Hollings law, or at least one of the very severe flaws in it. In previous times, OMB has come here with overly optimistic economic assumptions, overly optimistic interest rate assumptions, assumptions that we knew and I suspect you probably knew were not accurate, all in an effort to minimize the deficit, to give us a deficit number that was considerably below what the real deficit was going to be, and creating a partisan squabble between the administration and the Congress, but more importantly, I think, creating an era or an aura of mistrust on the part of the American people and the financial community and others, including foreign governments and foreign bankers and creditors abroad.

So, we do have today an honest estimate I think of the deficit. You are to be commended for that. I think that is a result of our budget summit agreement and also a result of the fact that Gramm-Rudman-Hollings is in suspense for all practical purposes for the next 2 or 3 years.

I would be remiss if I did not say this also: I share some of Senator Riegle's concerns about our economy. I know what the academic economists are telling us. I know what our own Congressional Budget Office is telling us. I hope and pray that this is a short, mild recession, but somehow I feel in my bones that that may not be the case.

This could be a recession for which we are quite unprepared, by way of not being able to exercise the traditional countercyclical fiscal policy or economic policy that we have done in the past, because of the large deficits. We are faced with a very, very fragile financial community now, the financial services industry. We still have not quit funding or stopped funding the bailout of the savings and loan industry.

Yet, at the same time we may see looming on the horizon very serious problems in the Federal Deposit Insurance Corporation. I

am concerned about the inability of American industry to compete domestically and abroad. That is one reason we are seeing these GM layoffs. The truth is, GM is not able to compete as they did 10 or 15 years ago, in my judgment.

So, we could be really—and I do not mean to overstate this, and I sincerely hope I am wrong—but we could be coming up to the precipice and looking over, and we do not have many tools to deal with it. So, I just want to follow on what Senator Riegle said and urge you to put the best minds in the administration to work in trying to come up with some contingency plans, in the event this economy gets worse, rather than better, in the short term.

Senator Domenici?

Senator DOMENICI. Mr. Chairman, I too want to thank the Director. I also want to thank Senator Lott. You did a good job today. You made public peace with the Director. That is wonderful. We ought to invite him to the next budget meeting.

Let me say two things: One, Mr. Chairman, from the standpoint of the war in the desert and our allies paying their share, first, I believe the administration—all things considered, is doing a very good job of convincing our allies and seeing to it that they commit, and I compliment them for it. It is a very extraordinary situation. We do not have any in our history like this.

But I think we have to also understand that those countries are somewhat reluctant and/or remiss sometimes to listen to us, the Congress. I think we ought to focus our attention more on them than our President or our Secretary of State. I think we ought to be telling the Japanese why we think they ought to pay, just as we discuss trade policies publicly. Sometimes we do not do it quite right, but on this one I think Germany and Japan ought to know from the legislature of the United States, at least from our standpoint, the Senate, that we expect it. I think they might respond, knowing that not only the President expects it, but we do.

Now, having said that, let me talk about the recession for a minute and the banks and S&L's and the overall financing mechanisms in this economy. While I am not as pessimistic as my friend the Chairman, I do not know if there is anything we could do to counter this recession of a countercyclical nature, and I do not think we are held down by deficits.

I think we have learned that many of our efforts to get out of a recession have really been window dressing. Now, that is not to say that automatic spending increases for unemployment compensation and other programs should not occur. Those programs are absolutely necessary. But I am talking about a new jobs bill and a new jobs program we might create. That kind we have looked at, and history reveals that, more times than not, it did not do any good. They came in just about the time the recession was over or they went to the wrong people or they primed the wrong industry or business.

So, I am not sure there are any new programs that will help us out of this recession. In the past, we used tax policy to get out of recessions. We did not find that that had much instant stimulus, either. If it was good tax policy, it affected us over a long period of time.

So, from my standpoint, if this administration or any of us have any good ideas, there is nothing worse for America than a reces-

sion. There is nothing better for America than that we grow. There is nothing more positive than the people have jobs, and that is better than government programs. It takes care of 85 to 90 percent of America, that is, those who are able-bodied and not retired.

So, I am for whatever we can do to get the economy going again. I would be remiss, Mr. Darman, if I did not tell you that I notice a slight difference in this recession and it does sort of worry me, and that has to do with the rather wholesale devaluation of real estate and assets that hold up the enormous indebtedness of our people and our businesses and our institutions.

It is nothing new. We have been busy doing that for a long time, getting these debts out there. But I am fearful, when real estate values begin to fall, no one knows where the real value is. I say to my friend from Mississippi, Japan is quite convinced that their real estate, which is in many instances a thousand times more expensive per square foot than ours, is the right value, and it holds up mortgages and indebtedness. Fine, as long as it holds.

But it does bother me that our financial institutions are suffering a double-whammy, the one I just described, which is real, and an imposition of regulatory excellence on them, real or perceived, that is causing them to be reluctant to lend money. It does concern me, because I believe normally the best way to get out of a recession is with lower interest rates to get capital out there for business to invest and grow and be competitive, but the response to reduced interest rates by the Federal Reserve is not showing itself to be very effective yet.

I do not expect you to take much time on this. I just tell you my concern, but I do want to compliment you on the budget and make two pledges to you: I want to try to see the $15 billion program go for the States. I hope the governors will help us, not just Republicans, but Democrats and Republicans. I hope it is as close to being an entitlement for a while as possible, Otherwise, we cannot tell our governors to accept it, because this Congress will cut it first. You can count on that.

Second, I want to try—and I tell our Chairman this—even though we do not always agree on where we are going and on the choices, I want to try to use this committee to take some votes on some choices and some priorities.

In the past, you know, it has all been "leave it alone, the appropriators will take care of it," and ultimately it may be their jurisdiction. But I think the Senate would like this debate. I think the people might be interested in the Administration's proposed project terminations and the choices we might make, instead of the choices that fall upon us by maintaining the immortality of all programs.

So, that is essentially where I come down. Again, I thank you for today's budget performance and the budget document.

I think, Mr. Chairman, it is good that we are telling the public that the deficit is $318 billion. I think they now know that $111 billion of it is the S&L bailout. Ten days ago, they did not understand that. I think they know that $50 billion of it is because we are in a recession. I think they know about social security now, at least a little better. We can have that debate for the rest of the year, I guess.

So, I look forward to a good year and I think the people on my side, Mr. Chairman, are interested and anxious to be participants, and you and I ought to see to it that they are this year. I think it would be helpful.

Chairman SASSER. Thank you.

Senator Lott, do you wish to have the last word here this morning?

Senator LOTT. I had not anticipated it, but I hate to pass up this opportunity, but no thank you. [Laughter.]

Chairman SASSER. Thank you very much.

Mr. DARMAN. Could I say thank you?

Chairman SASSER. Yes, indeed you certainly may.

Mr. Director, we are delighted to have had you here this morning and you have been very patient for 3 hours and 15 minutes. We will have some questions for the record, which I am sure you will answer expeditiously.

Mr. DARMAN. Thank you, Mr. Chairman.

Chairman SASSER. At this point, I have a statement for the record by Senator Kasten for this hearing, which will be inserted, without objection.

[The prepared statement of Senator Kasten follows:]

PREPARED STATEMENT OF SENATOR ROBERT W. KASTEN, JR.

Than you Mr. Chairman. I want to commend the President for sending to Congress his blueprint for a strong and vibrant America. I agree with many of the themes and priorities that have been outlined in his budget proposal.

Unfortunately, one thing this budget makes clear—is that the U.S. economy is in a recession. But we have the ability to get out of this economic downturn—we need to enact pro-growth tax legislation.

The President has made the commitment to cut the tax rate on capital gains. This cut in the tax rate will produce a $3 billion revenue increase in 1992. More importantly, it will promote economic growth and create jobs. However, this is just one part of a pro-growth package.

Another important proposal that I had hoped would be in the budget is a payroll tax cut. This tax cut on working families and small businesses would also spur growth and jobs—and will have no effect on our efforts to meet the statutory Gramm-Rudman targets.

A number of us on the Small Business Committee will be pushing hard to see these pro-growth incentive-based economic policies enacted into law.

I also believe that establishing enterprize zones will surely bring economic growth to hard hit areas. The whole concept of empowerment—giving the people the chance to make their own decisions—will prove to be the best decision we can make for Americans.

Chairman SASSER. Thank you all very much. The committee is adjourned.

[Whereupon, at 1:12 p.m., the committee was adjourned.]

WRITTEN QUESTIONS FROM SENATOR CONRAD TO MR. DARMAN AND THE RESPONSES

Question. Medicare claims payment operations would be cut by 2.5% in FY 92 under your budget proposal. Also, for the third year in a row, the Administration proposes to freeze Medicare's enforcement activities which *save* about $10 for every $1 spent by detecting Medicare fraud and improper billing. During the period of this freeze, Medicare outlays will have increased by over 30 percent resulting in several billion dollars in excess Medicare spending which could have been prevented. I agree with the General Accounting Office that this is a classic example of being penny wise and pound foolish. These repeated cuts have cost us billions more while saving a few million in administrative costs.

How do you expect to prevent massive backlogs in the payment of Medicare claims and sharp increases in Medicare fraud and waste when you are proposing to cut Medicare's claims payment operations by 2.5% while total Medicare outlays continue to increase at double-digit rates?

Answer. In January 1991, the Health Care Financing Administration (HCFA) informed Medicare contractors that, due to potential FY 91 budgetary shortfalls, it may be necessary to increase processing time for claims. Due to budgetary constraints, HCFA encouraged Medicare contractors to increase the number of electronic claims, which are faster and less expensive to process. HCFA's FY 92 claims processing budget is approximately $90 million over the FY 91 level and should permit contractors to continue meeting the statutorily required processing time for both paper and electronic claims. OMB will continue to monitor carefully contractor funding requirements to assure ongoing timely payment of claims.

Contractors perform payment safeguard activities, which include conducting medical review of claims to ascertain whether services are medically necessary and constitute an appropriate level of care, the auditing of provider cost reports and assuring that Medicare is the secondary payer if a beneficiary's services are covered by private insurance. Although the FY 92 budget for payment safeguards remains constant at the FY 91 level, HCFA is better targeting areas of maximum benefit per dollar input.

WRITTEN QUESTIONS FROM SENATOR DOMENICI TO MR. DARMAN AND THE RESPONSES

Question. Please submit a summary of OMB's general approach to program/project terminations.

Answer. OMB's general approach to funding programs under the discretionary caps to allow for shifting priorities and recognize a more dynamic concept of program lifecycles. In the past, programs too often became immortal. With a limited pool of discretionary resources, some programs must be reduced or terminated to make room for important program expansions. No resources were included for projects that were funded outside of normal procedures (i.e., projects that did not meet programmatic standards established by Congress itself, in authorizing statutes or by published agency regulations). Other programs were terminated if studies or evaluations showed them to be ineffective or inefficient. In addition, judgment was used to reduce or terminate programs felt to be ineffective or of low priority, given the variety of pressing demands for Federal funds.

Question. Please submit OMB's definition of "long-term investment" for the record.

Answer. "Long-term investment" includes programs that generally have returns accruing over a period greater than five years. The program areas that are included are those that are primarily for physical capital (such as highways), research and development, and education and training. The "short-term benefits" category covers program areas for which benefits accrue primarily within five years.

The "core Government" category includes program areas that are primarily for the central functions of the Federal Government. This category incudes the operations of the Postal Service (the mandatory portion of subfunction 372); the discretionary portion of the water transportation subfunction (403), because it is largely for the Coast Guard; the administration of justice function (750), except criminal justice assistance (754), which is largely grants to States and localities; and the general government function (800), except general purpose fiscal assistance (806), which is also largely grants to States and localities.

Question. From your presentation and from the Budget document you show [domestic] discretionary programs *going up* and some *down* for 1992. Those break down in the budget as:

	1992 amounts in billions	
	Budget authority	Outlays
Terminations	−0.1	2.4
Reductions	19.1	18.2
Subtotal	19.0	20.6
Major increases	117.7	131.3

	1992 amounts in billions	
	Budget authority	Outlays
Total	136.8	151.9
Caps for 1992	200.1	212.1

[The above table includes some minor corrections to the table originally submitted with the question.]

What is happening to all those other domestic discretionary programs, they must *also* be increasing substantially?

Answer. The budget request for domestic discretionary programs in 1992 totals $197.4 billion in budget authority, $9.4 billion more than the 1991 enacted budget authority level of $187.9 billion. The proposed $9.4 billion net increase from the 1991 enacted level includes: decreases of $12.9 billion for programs that are proposed for termination or reduction (see Tables B–4 and B–5, Part Two, pages 356 and 358–9) of the *1992 Budget*; major increases of $17.8 billion (see Table B–6, Part Two, page 364); smaller increases of $3.8 billion for other programs; and net increases of $0.7 billion for user fee proposals and the shift to the new credit accounting structure.

Question. Attached is a table prepared by CBO that shows that distribution of Federal benefits by income catagory. Have you prepared a similar table showing the distribution of Federal benefits? If not, could you supply the committee with such a table based on the Administration's analysis?

Answer. The attached OMB table provides 1989 data underlying the two charts on page 136 of Part Two of the 1992 Budget. It is similar to the CBO table. Several differences should be noted: Only cash transfers are reflected on the attached table, not Food Stamps or Medicare; Federal civilian and military retirement are not reflected on the attached OMB table; The income brackets on the attached OMB table reflect total *per capita* money income, rather than the income of families and unrelated individuals that appears to be reflected in the CBO table, and The CBO table provides estimated distributions for 1991, while the OMB table reflects 1989, the last year for which actual data are available.

Both the OMB and CBO tables reflect some benefit amounts that are funded by non-Federal sources. As a rule, household survey data, such as that used for the OMB table, do not differentiate Federal from non-Federal portions of benefits such as AFDC, SSI, and Medicaid.

CBO table that accompanied the question.

TOTAL TRANSFERS BY INCOME CATEGORY, 1991

INCOME CATEGORY	NO. OF FAMILIES	SOCIAL SECURITY	UI+VETS +WKRCMP	AFDC+ SSI+GA	FOOD STAMPS	MEDICARE	CIVILIAN PENSIONS	MILITARY PENSIONS
UNDER $10,000	16840.	33260.	2862.	16533.	6677.	19592.	306.	129.
$10,000-$20,000	19331.	56343.	6013.	6687.	2011.	24586.	2231.	1119.
$20,000-$30,000	17442.	46421.	6150.	1983.	437.	18885.	4289.	2576.
$30,000-$40,000	13951.	33564.	4341.	1082.	122.	13180.	5032.	3446.
$40,000-$50,000	10230.	21730.	3862.	595.	51.	8548.	4096.	3119.
$50,000-$75,000	13957.	26653.	4815.	679.	39.	10350.	6611.	5832.
$75,000-$100,000	5630.	9232.	1654.	215.	19.	3794.	2738.	2799.
$100,000-$150,000	3163.	6200.	907.	49.	2.	2423.	1937.	2733.
$150,000 OR MORE	2052.	5910.	349.	45.	5.	2213.	2187.	1561.
ALL INCOMES	103907.	240313.	31243.	27975.	9624.	103984.	29502.	23356.

FAMILY COUNTS IN THOUSANDS

SPENDING AMOUNTS IN MILLIONS OF 1991 DOLLARS

OMB table that accompanies the answer.

Calendar year 1989 (March 1990 CPS)

Per capita cash income	Number of Persons (millions)	Total cash Transfer income (millions)	Social Security & Railroad Retirement (millions)	UI, Vets & Wrkrs comp (millions)	AFDC, SSI & Gen'l assistance (millions)
Negative	1.9	$141	$107	$21	$13
$0 - $2k	13.1	$7,988	$1,236	$470	$6,283
$2k - $4k	20.9	$17,665	$8,195	$1,580	$7,890
$4k - $6k	25.7	$31,135	$23,359	$2,693	$5,083
$6k - $8k	27.4	$36,136	$30,044	$3,432	$2,660
$8k - $10k	25.4	$30,870	$26,308	$3,208	$1,355
$10k - $12k	23.1	$25,240	$21,390	$3,143	$707
$12k - $14k	20.1	$21,155	$17,920	$2,838	$397
$14k - $16k	15.4	$17,374	$14,676	$2,395	$302
$16k - $18k	13.1	$13,281	$10,674	$2,339	$268
$18k - $20k	10.2	$9,922	$8,304	$1,536	$82
$20k - $22k	8.9	$8,382	$6,822	$1,461	$99
$22k - $24k	6.8	$7,164	$5,710	$1,402	$52
$24k - $26k	6.2	$5,424	$4,308	$1,081	$35
$26k - $28k	4.4	$4,385	$3,725	$600	$60
$28k - $30k	3.7	$3,161	$2,460	$702	$0
$30k and above	19.9	$18,503	$14,794	$3,658	$51
Total	246.2	$257,926	$200,032	$32,555	$25,339
Officially poor	31.7	$32,706	$15,594	$1,873	$15,239
Officially nonpoor	214.5	$225,219	$184,437	$30,682	$10,100
Pre-transfer poor	49.2	$124,568	$92,670	$10,695	$21,202
Pre-transfer nonpoor	196.9	$133,358	$107,362	$21,860	$4,136

2/25/91

WRITTEN QUESTIONS FROM SENATOR GRASSLEY TO MR. DARMAN AND THE RESPONSES

Question. OMB analysis of subsidy value provided through cargo preference.

Answer. Current law requires at least 75 percent of all agricultural shipments be reserved for U.S.-flag carriers, as well as 100 percent of DOD cargo (the DOD component accounts for nearly two-thirds of the cargo preference program total costs).

In part, cargo preference represents a hidden subsidy. That is, the portion of the program related to Defense cargoes and USDA and other federal agencies' agricultural cargoes shipped on U.S.-flag vessels (under P.L. 480 or section 416 food aid). The remaining portion of the cargo preference program is reflected in the Maritime Administration's (MarAd) Ocean Freight Differential account, and, thereby, does not represent a hidden subsidy. Through this account, MarAd directly assists U.S.-flag vessels carrying preference cargo through reimbursing the USDA for the final one-third of cargo preference costs (USDA pays the first two-thirds of the costs).

OMB is aware of the Congressional Budget Office study and its concern related to the Maritime subsidy programs and policies. OMB agrees that the study has served a very useful purpose in shedding light on cargo preference as a particially hidden subsidy. However, as a recent GAO study (June 1990) on cargo preference stated, the transportation costs associated with shipping food aid under cargo preference have steadily decreased through the 1980s. Since 1981, the average cost differential between U.S. and foreign flag shipping rates for food aid under Titles I and III of P.L. 480 has decreased by more than 50 percent.

Question. Provide an update on the Defense Management Review.

Answer. As a follow-on to the proposals in last year's Defense Management Report, additional initiatives are being proposed in the 1992 budget which will result in savings of about $.7 billion in 1992, growing to $2.9 billion by 1996. These and last year's proposals are projected to save over $72 billion during the 1991–1997 period.

The 1992 initiatives include functional consolidations and streamling of activities such as supply depots, inventory control points, research and development laboratories, maintenance facilities and finance and accounting centers. Efforts which are continuing from last year's management review include consolidation of contract administration functions, consolidation of commissary operations, reductions in consulting costs and implementation of a corporate management information system.

Also included in the budget is a proposal to create a Defense Business Operations Fund, a revolving fund, from which customers would purchase supplies, maintenance, accounting, ADP services and other support. The goal is to highlight the full costs of support activities while allowing operating units to determine the supplies and services needed for specific activities to be undertaken. Long term savings should result from this change to Defense's financial management system.

WRITTEN QUESTIONS FROM SENATOR NICKLES TO MR. DARMAN AND THE RESPONSES

DESERT STORM

Question. From the beginning of the war until February 4, Israel has suffered 7 Scud missiles attacks, carrying 26 missiles. The missiles and debris from the 13 Patriot intercepts have all struck civilian populations, bringing terror and destruction on the people of Israel.

And, while Israel has not entered the "shooting war", it has assumed enormous financial costs since the beginning of the Gulf crisis, currently estimated at over $3 billion.

These costs include the maintaining of a constant high state of military alert; increasing training missions and resupplying and stockpiling weapons and ammunition; growing fuel costs; enhancing civil defense measures; and rebuilding parts of Tel Aviv.

Is the Administration planning to include additional military assistance to Israel as part of the Desert Storm supplemental appropriations bill?

Will funds for foreign countries directly affected by the war be deemed "emergency" spending along with the defense related spending included in the Desert Storm supplemental?

What is the current time frame for sending the Desert Storm supplemental to the Hill?

Answer. The Desert Shield/Storm supplemental request of February 22, 1991 contains only funding associated with the Department of Defense and with the incremental cost of the operation in the Middle East as specified in the Budget Enforcement Act.

A companion supplemental package also transmitted on February 22, 1991, contains requests for emergency appropriations for the Department of State, the United States Information Agency, and the Agency for International Development. These cover the operations associated with the Persian Gulf crisis. No foreign assistance requests either for Israel or other countries involved in the crisis are contained in this package.

CREDIT REFORM

Question. The new credit reform laws require a country analysis to be prepared by OMB in order to determine the cost to the U.S. government of credit programs for foreign countries.

I understand that OMB has prepared a country analysis that groups certain countries together, and shows a cost for credit programs for these various groupings. Does this not harm countries that have perfect or near-perfect credit ratings?

Are you considering separating out certain countries, that are U.S. allies, that do have excellent credit ratings, so they would not suffer from the lesser credit ratings of other countries?

Answer. New credit reform legislation does not require OMB to prepare a country analysis to determine the cost of credit programs. Credit reform costs are estimated by the federal agencies with credit programs, in consultation with OMB. Many agencies (e.g. AID and USDA) have estimated each country's credit rating by extrapolating from that country's past payment record. In these cases, countries with perfect or near perfect ratings have not been lumped with lower-ranked countries. In other cases (e.g. Eximbank), country categories are used since future country by country lending is uncertain. Nonetheless, this approach should in no way harm countries with perfect or near perfect credit ratings since they will be in the top category by themselves.

WRITTEN QUESTIONS FROM SENATOR SIMON TO MR. DARMAN AND THE RESPONSES

Question. The new credit reform laws require a country analysis to be prepared by OMB in order to determine the cost of the U.S. government of credit programs for foreign countries.

I understand that OMB has prepared a country analysis, that groups certain countries together and shows a cost for credit programs for these various groupings. Does this not harm countries that have perfect or near-perfect credit ratings?

Are you considering separating out certain countries that are U.S. allies, that do have excellent credit ratings, so they would not suffer form the lesser credit ratings of other countries?

Answer. New credit reform legislation does not specifically require OMB to prepare a country analysis to determine the cost of credit programs. Credit reform costs are estimated by those Federal agencies with credit programs, in consultation with OMB. Many agencies (e.g. Agency for International Development and U.S. Department of Agriculture) have estimated each country's credit rating by extrapolating from the country's past payment record. In these cases, countries with perfect or near perfect ratings have not been lumped with lower-ranked countries. In other cases (e.g. Eximbank), country categories (based on macroeconomic performance) are used because lending to individual countries is not determined in advance. Neither approach should in any way harm countries with perfect or near perfect credit ratings because their good repayment performance is recognized.

BUDGET OF THE UNITED STATES GOVERNMENT

DIRECTOR'S INTRODUCTION AND OVERVIEW TABLES

FISCAL YEAR 1992

II. DIRECTOR'S INTRODUCTION AND OVERVIEW TABLES

A SOMBER MOMENT—BUT WITH HOPE FOR A NEW ORDER

Last year's budget was published in an historical context that bordered on the euphoric. Its introduction noted:

> State-centered, command-and-control systems seem to be decomposing.... Liberated celebrants have cheered the opening of the Berlin wall and the decline of communist dictators. So too have liberated Panamanians celebrated the fall of the dictator in near-by Panama....
>
> This is not small stuff. It is another giant leap of the human spirit yearning to breathe free.

The introduction, then, went on to lament:

> Yet this great historical shift has been almost trivialized in its translation into public debate about the budget. The issue has been framed as: "How big is the 'peace dividend'?"—and, in effect, "How can I get mine?"

This year's budget goes to press at a more somber moment, when the fragility of peace has again been made painfully evident. In August, a militaristic dictator brutally invaded a peaceful neighbor. He refused to conform to international norms established by the United Nations. He destabilized a region that is vital to the global economy—a region which, for too long, has been the victim of conflict.

As a result, suffering has increased within the region and throughout the world. Innocent people have been hurt. Economies have weakened. Allied military action has been undertaken as a last resort to enforce the resolutions of the United Nations. The early action has gone well. But precious lives have been lost. The poignant human costs of protecting freedom and the civilized rule of law have again been made clear.

Yet, although the moment is somber, there is cause for hope.

The liberation of Kuwait has begun. But of more far-reaching significance is this: With U.S. leadership, the global response to the Iraqi invasion has the potential to set a favorable precedent for the post-Cold-War era—what the President has termed a New World Order.

At home, the Iraqi invasion of Kuwait has caused obvious economic difficulties. Oil prices were driven up for several months. Long-term interest rates reflected a risk premium. In the face of uncertainty, consumers and investors have understandably held back. The resulting economic slow-down has taken its toll. And the problem of the fiscal deficit has thus been compounded by the effects of the crisis in the Gulf.

Yet in this somber domestic picture, too, there is cause for hope. The move toward satisfactory resolution of the Gulf crisis is unequivocally positive for the domestic economy. And the residual fiscal crisis, though regrettable, has the potential to foster—even to accelerate—domestic reform. Within the framework of the 1990 Budget Agreement, constructive reforms can be framed. Though less grand than a New World Order, steps toward a new domestic order can continue to be advanced—at least at the margin of practicable change.

It is in this spirit that the new budget is presented.

This introduction:

- reviews the deficit outlook;
- outlines a reform agenda; and
- discusses the need for a new conception of "program life cycles"—within the framework of the 1990 Budget Act.

THE DEFICIT OUTLOOK—WORSE BEFORE BETTER

The new budget is for fiscal years 1992 and beyond. For each of these years, the consolidated deficit estimate promises to be better

than the year before. The projected deficit goes down by $37 billion from 1991 to 1992. It reaches balance by 1996. (See Table II–1.) As a percent of GNP, it declines from 5.7 percent (near the recent high of 6.3 percent in 1983) to roughly 1 percent in the mid-1990s. The *longer-term* trend is favorable by several different measures of "the deficit." (See Chart II–1). But the inescapable reality of the *near term* is: the deficit outlook is not good.

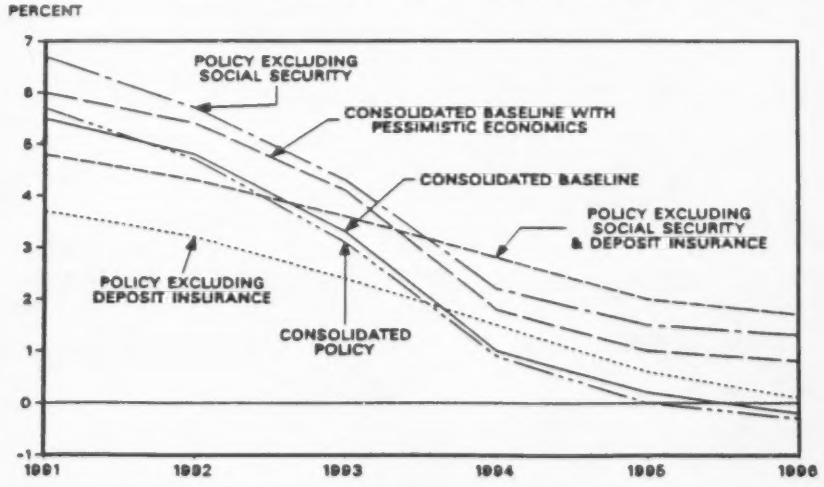
The consolidated deficit for the current fiscal year, 1991, is estimated at $318 billion. This includes $30 billion in budget authority and $8 billion in outlays (net of foreign contributions) as a placeholder for the incremental costs of Operation Desert Shield. This does not fully cover the additional costs of actual combat, however. With substantial foreign contributions, the adverse financial effects on the United States should be mitigated. But neither full costs not total contributions can be reliably estimated as the budget goes to press.

Even without the full net costs of Desert Shield (which includes Desert Storm), this

Table II–1. **DEFICIT ESTIMATES, 1991–1996**
(In billions of dollars)

	1991	1992	1993	1994	1995	1996
Consolidated Baseline	–310.3	–284.9	–212.3	–67.5	–12.1	14.1
Consolidated Baseline with pessimistic economics	–336.1	–326.0	–262.1	–126.3	–75.3	–61.4
Consolidated Policy	–318.1	–280.9	–201.5	–61.8	–2.9	19.9
Policy excluding Social Security	–378.6	–343.3	–274.9	–151.1	–106.8	–101.9
Policy excluding Deposit Insurance	–206.6	–192.8	–157.3	–99.9	–45.3	–10.0
Policy excluding Social Security and Deposit Insurance	–267.1	–255.2	–230.7	–189.2	–149.1	–131.8

Chart II-1. DEFICITS AS A PERCENT OF GNP



1991 deficit estimate represents a substantial deterioration relative to the 1990 deficit of $220 billion. It is worse than was estimated last summer, by both the Administration and the Congressional Budget Office, during the Budget Summit negotiations. And it is far worse than the baseline deficit estimated a year ago.

The two largest elements of this deterioration for 1991—each far greater than all others combined—are:

- an increase of $105.5 billion in estimated outlays for thrift and bank insurance (part of which is due to a change in accounting treatment); and
- a decrease of $87 billion in estimated receipts (principally due to a weaker economy).

The longest period of peacetime economic growth has been interrupted. Revised economic assumptions now reflect two consecutive quarters of negative real growth—the fourth quarter of calendar year 1990 and the first quarter of calendar year 1991. (See Table III–1)

This temporary economic downturn was not assumed last year by the Administration or by most outside economists. Indeed, it was not the result of ordinary causes. It did not start as a turn of the "business cycle." Inventories were relatively low. And it was not a correction for "overheating."

Among the principal causes of the weaker economy were a combination of the following:

- *monetary policy*, which for an extended period (roughly two years) remained on the tighter side of its target range—not seeking to halt real growth, but slowing growth out of concern for inflation and dollar weakness;
- the *"credit crunch"*—as the banking system (both banks and regulators) struggled to react to the S&L experience, new capital requirements, problems in the real estate market, and fears of a more general slowdown; and,
- perhaps most significantly, the multiple adverse economic and psychological effects of the *crisis in the Gulf* (as noted above).

The return to healthy economic growth—and the associated improvement in the deficit—assumes, and probably requires:

- improvement in all three areas—the Gulf, the financial system, and monetary policy;
- adoption of the growth-oriented policies noted in the President's Message and discussed further below; and
- full implementation of the 1990 Budget Agreement—which reduces the previous baseline deficit by $72.9 billion for 1992 and $138.1 billion for 1995.

As always, there is a risk that these are excessively hopeful assumptions. But with the new Budget Agreement, the risk is arguably lower than in previous years.

Prior to enactment of the Agreement's procedural reforms, there were incentives for the Administration to err in the direction of rosy projections. There were related incentives for the Congress first to criticize these projections (visibly) and then to adopt the same projections (invisibly). Now, these perverse incentives have been reduced.

For this and other reasons, the Administration's projections are closer to mainstream thinking. The calendar year 1991 real growth forecast is almost identical to the current consensus forecast of the "Blue Chip" economic experts, and is actually below that of the Congressional Budget Office (CBO). The long-term growth forecast, although higher than that of CBO, is nonetheless below America's post-World-War-II average. Thus, the deficit outlook presented here may be judged to be more credible than in the past.

Unfortunately, however, this does not necessarily mean that it is correct. Even in the best of times, macroeconomics is a highly fallible "science." (Macroeconomists are often closer to each other than to reality.) And as this budget goes to press, there are crucial unknowns: the timing and character of events necessary to resolve the crisis in the Gulf. These are fundamentally relevant uncertainties. Much will turn on them.

So Chapter III, "Economic Assumptions and Sensitivities," bears special attention. It discusses the extent to which the deficit outlook

should be modified if one wishes to use different economic assumptions.

REFORMIST STEPS—TOWARD A NEW DOMESTIC ORDER

Whatever one's economic assumptions, America nonetheless can—and must—continue its historic mission: protecting freedom, accelerating innovation, assuring fairness, increasing growth and opportunity, while limiting the expansion of intrusive and inefficient government. The President's 1992 budget limits the growth of Federal spending to 2.6 percent—less than the inflation rate. Within this limit, it nonetheless helps advance the process of American renewal. The budget proposes reform measures in each of the following domestic areas:

(1) Education Reform

The United States spends more per student on education than almost every other country on earth. Yet, the average performance of American elementary and secondary school students on internationally administered tests is disgracefully low. The performance is below that of America's major trading partners. It falls consistently near the bottom. The current system unnecessarily holds young people back, holds workers back, and holds the Nation back. Clearly, more of the same cannot be acceptable.

In coordination with the Nation's Governors, the President has initiated an ambitious national reform effort. Consistent with that reform effort, the budget gives special emphasis to increased investment in child care (including almost $10 billion in tax credits and $732 million for the new child care block grant), Head Start ($2.1 billion), compensatory education ($6.4 billion), mathematics and science education ($1.9 billion), and the measurement of results.

To accelerate the more basic reforms that are necessary, the budget provides $690 million for a new Educational Excellence Act. And, perhaps most importantly, it encourages increased parental choice through: demonstration grants, greater flexibility for States, an information clearinghouse, and a new incentive fund for States and localities that adopt choice-oriented certificate programs. Greater choice would help foster a more market-like system and hold schools more accountable for performance. It is only with performance-based choice that more fundamental reform is likely to be achieved. (See Chapters IV.A. and V.A.)

(2) Research and Development

America's long-term position internationally and the potential for improvement in life at home depend fundamentally upon investment in a strong R&D base. Unfortunately, short-term claims and pressures often tend to drive out long-term investment. R&D is especially vulnerable in both the public and private sectors. Since the 1960s, investment in civilian R&D, particularly, has experienced a troublesome decline as a percent of GNP. To counter these tendencies, the President's budgets have sought to protect and increase R&D investment—without having the government cross the line into the problematic area of "industrial policy."

This budget proposes to make the R&D tax credit permanent in order to encourage more private R&D; while it also increases the direct Federal investment to $76 billion for 1992—up $8.4 billion to the highest level ever. Basic research would increase to $13 billion, with pathbreaking efforts that range from high-energy physics to what promises to be one of the most important and far-reaching research projects in human history: the Human Genome Project. In applied civilian R&D, exciting investments range from materials processing, to biotechnology, to high-speed rail transport and electric battery technology, to high performance computing. This investment in R&D unquestionably has the potential—in time—to bring radical improvement in the quality of human life across-the-board. (See Table II–2 and Chapter IV.C.)

(3) Financial Sector Reform

The S&L crisis was a central focus of reform last year. This year, public attention has begun to shift to the risks associated with banks. While the analogy with S&Ls is not appropriate, there unquestionably are risks. From a budgetary perspective, they are reflected in the baseline projection for the Bank Insurance Fund. In the absence of remedial

Table II–2. ENHANCING RESEARCH AND DEVELOPMENT AND EXPANDING THE HUMAN FRONTIER—HIGHLIGHTS
(Dollar amounts in millions)

	Budget Authority			
	1991 Enacted	1992 Proposed	Dollar change	Percent change
Basic Research				
Doubling the NSF budget	2,316	2,722	+406	+18
Increasing Basic Biomedical Research at NIH	4,634	4,968	+334	+7
Human Genome Project	135	169	+35	+26
Agricultural Research Initiative	73	125	+52	+71
Superconducting Super Collider	243	534	+291	+120
Applied Research				
High Performance Computing and Communications	489	638	+149	+30
Energy R&D	676	903	+227	+34
Advanced Manufacturing and Materials	1,316	1,310	–6	—
HIV/AIDS	1,152	1,210	+58	+5
Moving Fusion Energy from Science to Engineering	275	337	+62	+23
Aeronautics R&D	482	543	+61	+13
Expanding R&D at the National Institute of Standards and Technology	215	248	+33	+15
Maintaining National Security: Defense R&D	37,783	43,247	+5,464	+14
Expanding the Geographic Frontier: Space Exploration				
Space Transportation Infrastructure	4,801	5,517	+716	+15
Space Science	1,774	2,141	+367	+21
Mission to Planet Earth (Global Change)	954	1,186	+232	+24
Mission From Planet Earth	2,199	2,470	+271	+12
Expanding the Human Frontier through Biotechnology	3,788	4,107	+319	+8

legislative action, the Fund balance would turn negative in 1992. (See Chapter VIII.A.)

But the issues involved are far broader than merely the accounting status of the Bank Insurance Fund. Financial markets have become global. So has competition in financial services. Technological advances have changed both the character of services and of service-providers. Yet, the legal and regulatory framework attempting to govern the American financial service sector has not adapted. It is outdated—as will be many American competitors if the framework is not modernized.

With this problem in clear view, the President is proposing a comprehensive reform of both deposit insurance and the legal-regulatory framework governing the financial services sector. (See associated Treasury study.)

(4) Incentives for Saving and Investment

In the past decade, significant tax bills have been enacted at the rate of almost one per year—including historic tax reform. On balance, the tax system has been radically improved. As a general matter, both the tax system and the taxpayer deserve a rest. Still, there is one area that continues to merit further reform: the need to strengthen incentives for saving and long-term investment.

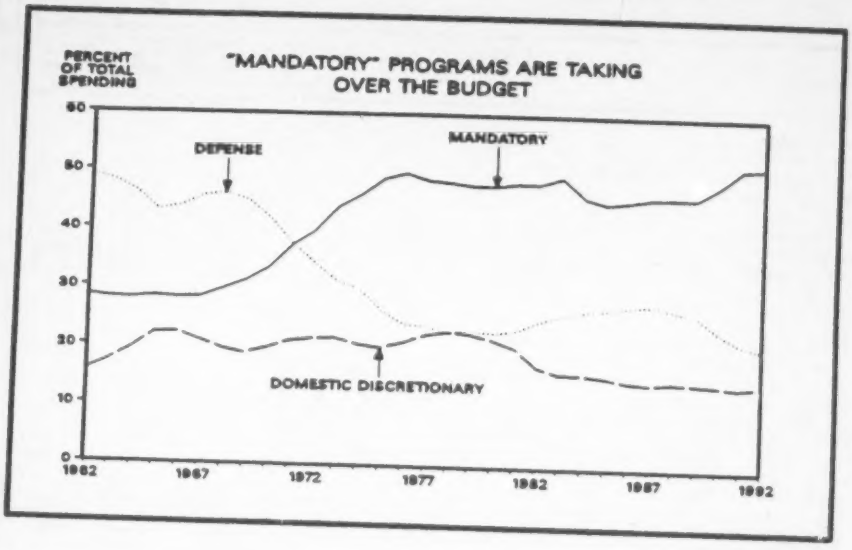
Accordingly, the President's budget proposes incentives to encourage: family savings, homeownership, longer-term investment, and investment in Enterprize Zones. (See Chapter X and the related discussion of pay-as-you-go requirements in Chapter XIV.)

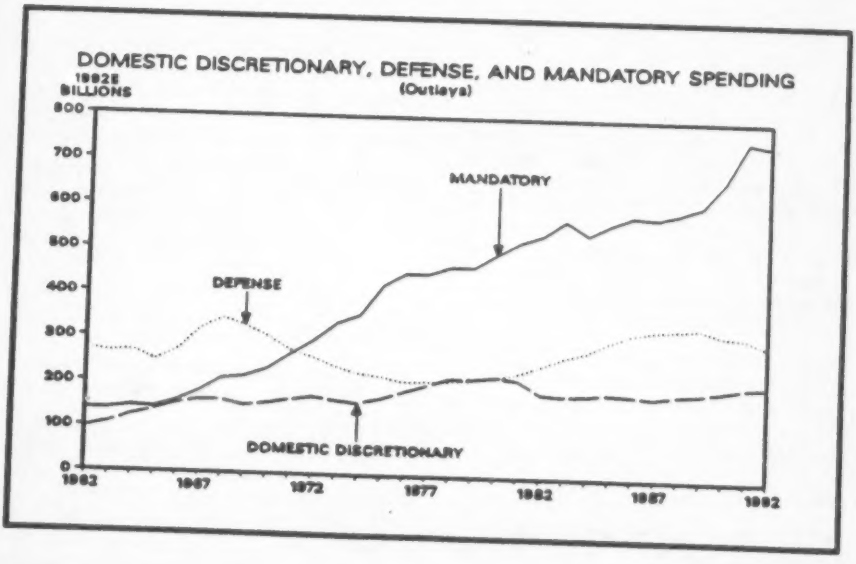
(5) "Entitlement" Reform

In looking at the changing composition of the Federal budget since the 1960s, two trends stand out:

- First, the budget is being taken over by so-called "mandatory" or "entitlement" programs. These are largely transfer payments, which are not now subject to annual appropriation. They have grown from 28 percent of the budget in President Ken-

Chart II-2.


"MANDATORY" PROGRAMS ARE TAKING OVER THE BUDGET
PERCENT OF TOTAL SPENDING
60
50
40
30
20
10
0
DEFENSE
MANDATORY
DOMESTIC DISCRETIONARY
1962
1967
1972
1977
1982
1987
1992


DOMESTIC DISCRETIONARY, DEFENSE, AND MANDATORY SPENDING
1992$ BILLIONS
(Outlays)
800
700
600
500
400
300
200
100
0
MANDATORY
DEFENSE
DOMESTIC DISCRETIONARY
1962
1967
1972
1977
1982
1987
1992

nedy's administration to nearly 52 percent today. (See Chart II–2).

- Second, within the "mandatory" total, funding for the non-poor has increased far more than for the poor. (See Chart II–3.)

No serious effort to address the deficit can ignore the 52 percent of the budget comprised by "mandatory" programs. That is why the 1990 Budget Act included measures to reduce the growth of "mandatories" by $100 billion over five years. But that is still not enough.

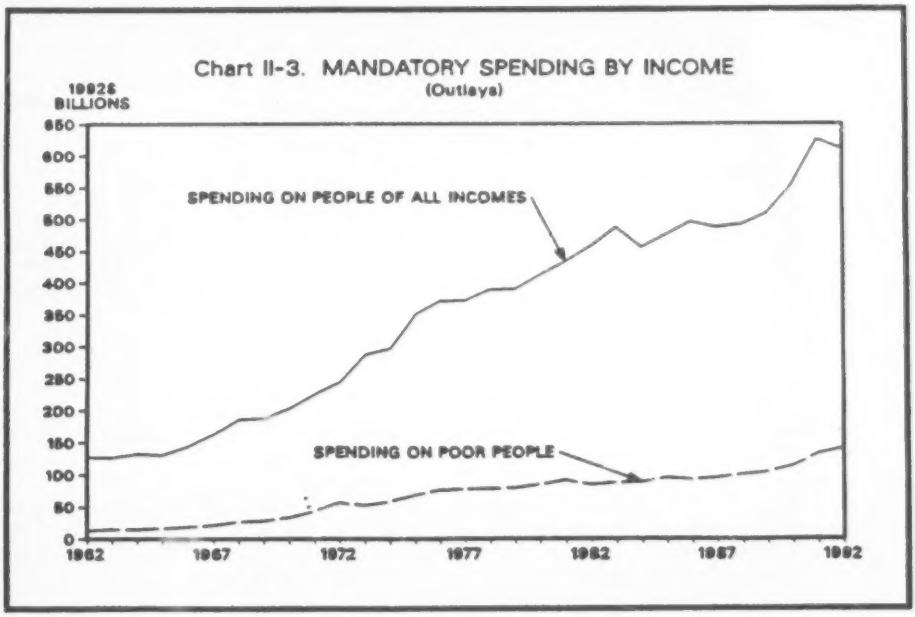
Accordingly, this budget proposes to reduce "mandatories" by another $47 billion over five years. (See Table II–9.) In addition, the budget reflects an important new emphasis for reform: increasing fairness in the distribution of benefits, reducing subsidies for those who do not need them.

In particular the budget proposes to: reduce the subsidy of Medicare "Part B" premiums for individuals with annual incomes over $125,000; restructure higher education assistance to serve the needy better; reallocate school lunch subsidies to increase benefits for those with greater need; standardize benefits to increase payments to survivors of lower-ranking military personnel; and limit farm subsidies for individuals with non-farm income over $125,000. (See Chapter V.C.)

(6) Health System Reform

Although the American health system leads the world in research and in many specialized areas, its general performance is not yet satisfactory. Its costs continue to grow faster than both inflation and the economy. Total national expenditures on health now claim 13.5 percent of GNP. Federal health spending is over 15 percent of the budget. This enormous and rising claim on resources comes at the expense of what might otherwise be the expansion of services for those who do not have fair or adequate access to the health system. And notwithstanding the huge expenditures, indicators such as infant mortality and preventable death and disease remain unnecessarily high.

The American health system is a hybrid—partly government-managed, partly private, partly in-between; partly a model of excellence,



and partly a disgrace. The challenge of reform is complex. Comprehensive reform plans abound. But none is a certain remedy, and some threaten to cause as many problems as they would cure. None is likely to be implemented quickly.

For the coming year, the Administration will continue to advance reform in manageable steps—implementing last year's expansion of access to Medicaid and the reform of Medicare's physician payment system, while also accelerating reform in two new areas:

- *Malpractice reform.* The budget proposes new Federal financial incentives for States to adopt model malpractice reform measures. This can help reduce both the direct costs of malpractice insurance and the indirect costs of "defensive medicine"—while expanding the availability of medical services and increasing attention to appropriate standards of care.
- *Investment in Prevention.* The budget proposes to fund a concerted effort—through both education and increased investment in preventive services—to stop avoidable health problems before they start. In doing so, it gives special emphasis to programs affecting children—and to prenatal care, infant nutrition, cancer screening, injury control, smoking cessation and other matters of personal responsibility. (See Tables II–3 and II–4, and see Chapter IV.B.)

(7) Drug Abuse Reduction

One of the most troubling breakdowns of personal responsibility is reflected in drug abuse. In the 1970s and 1980s, the problem grew to near-epidemic proportions. The President advanced the first National Drug Control Strategy in September 1989. Several recent studies have shown encouraging results. Cocaine use seems to have declined significantly from levels in the mid-1980s. But the drug abuse problem is far from solved.

Accordingly, the budget continues to increase the resources allocated to the National Drug Control Strategy. For 1992, the Federal share increases by $1.1 billion to $11.7 billion (80 percent higher than when the President took office). The increase in these resources is distributed to all elements of the Strategy. (See Chapter V.B.)

(8) Housing Reform

American public policy reflects a long-standing commitment to the importance of investment in housing. But the results have been mixed—and clearly unsatisfactory for many of the poorest Americans. Part of the problem has been conceptual: too great an emphasis on direct governmental ownership and management; too little emphasis on opportunities for poor people to benefit from choice and homeownership.

The budget reflects a reformist shift in concepts: It proposes to fund fully ($2.1 billion in 1992) the new HOPE program—creating opportunities for tenant management and ownership. It requests a 38 percent increase in vouchers for low income people—to increase their power in the marketplace. And, on the tax side: it would permit the use of Individual Retirement Accounts by young families and first-time homebuyers; and it would offer special incentives for investment in Enterprise Zones—a refundable tax credit for wages, expensing of investor purchases of new corporate stock, and a zero capital gains rate for investment in tangible property within Enterprise Zones. (See Chapter V.A.)

(9) Transportation Infrastructure Investment

The Nation's transportation systems are fundamental to both economic productivity and the quality of life. And the stresses upon these systems continue to mount. While attending to important limits on the Federal role and responsibility, the 1992 budget makes a major contribution to expansion and improvement of the transportation infrastructure:

- Annual obligations of the Highway Trust Fund would be increased to $16 billion in 1992 and to more than $20 billion by 1996. In seeking to reauthorize the Federal highway program, the Administration would simplify and strengthen the existing program—establishing a new National Highway System, giving States greater flexibility with a new block grant program, and allowing more innovative financing with private participation. In addition, the

Table II–3. SPENDING ON SELECTED PROGRAMS SERVING CHILDREN INCREASES 9.5 PERCENT IN 1992

(In millions of dollars)

	1990	1991	1992 Proposed
Nutrition:			
WIC	2,126	2,350	2,573
Child Nutrition	4,887	5,577	6,066
Other Nutrition	7,965	9,138	9,825
Health:			
Targeted Infant Mortality	—	[1]34	139
Medicaid	8,200	10,300	12,000
Community/Migrant Health	227	238	238
Immunizations	187	218	258
Maternal/Child Health	554	[1]554	554
Other Health	222	264	266
Education and Social Services:			
Head Start	1,552	1,952	2,052
Handicapped Education	2,055	2,467	2,730
Compensatory Education	5,368	6,225	6,424
Educational Excellence Act (proposed)	—	—	490
Precollege Math and Science Education	333	515	661
Child Care Block Grant	—	732	732
Foster Care	1,375	2,611	2,186
Social Security	8,375	9,048	9,716
Supplemental Security Income	1,261	3,531	2,497
Aid to Families with Dependent Children and Child Support	12,165	14,008	15,162
Other Education and Social Services	2,453	2,642	2,352
Refundable Tax Credits	6,287	6,941	9,973
Total Children's Funding	65,612	79,345	86,851

[1]Reflects HHS' plans to reprogram $34 million from MCH Block Grant to Targeted Infant Mortality in 1991. Overall resources supporting this initiative will total $57 million in 1991 and $171 million in 1992, including funds from other public health grants.

Table II–4. THE BUDGET PROVIDES INCREASES FOR PROGRAMS FOCUSED ON PREVENTION AND THE NEXT GENERATION

(Obligations in millions of dollars)

	1991 Enacted	1992 Proposed	Percent Increase
Childhood immunization	218	258	+18.3
Infant Mortality Initiative	7,335	8,011	+9.2
(Targeted Infant Mortality Initiative—non-add)	57	171	+300.0
Breast and Cervical Cancer Prevention	269	410	+52.4
Smoking Cessation	90	97	+7.8
Physical Fitness and Diet	122	139	+13.9
Accident and Injury Prevention	1,683	1,907	+13.3
Access to Preventive Health Care	5,410	6,026	+11.4
Family Planning	399	420	+5.3
Lead Poisoning Prevention	8	41	+412.5
Substance Abuse Prevention	1,442	1,515	+5.1

Table II–5. SELECTIONS FROM THE REFORM AGENDA—WITHIN THE FLEXIBLE FREEZE FRAMEWORK[1]

Area	Highlights
(1) Education Reform:	• Long-term national goals—with Governors • Special funding emphasis on early childhood ($87 billion) • Parental choice—new incentive fund ($200 million) • Educational Excellence Act ($690 million) • Higher education funding reform • Math/Science improvement program ($1.9 billion)
(2) Research and Development:	• Record level for R&D ($76 billion) • Record level for basic research ($13 billion) • Human Genome Project • Increased emphasis on applied civilian R&D (*e.g.*, materials processing, biotechnology, high-performance computing)
(3) Financial Sector Reform:	• Deposit insurance reform • Recapitalization of Bank Insurance Fund • Comprehensive reform of legal and regulatory structure to modernize financial services sector
(4) Incentives for Saving and Investment:	• Enterprise Zones • Family Savings Account • IRA withdrawal for first-home buyers • Capital gains modification for longer-term investment
(5) Entitlement Reform:	• $47 billion savings over 5 years • Increased fairness/reduced subsidies for wealthy
(6) Health System Reform:	• Physician payment reform • Malpractice reform • Increased investment in prevention (prenatal care, infant nutrition, cancer screening, education for personal responsibility, child care)
(7) Drug Abuse Reduction:	• National Drug Control Strategy • $1.1 billion increase—to record $11.7 billion (Federal share)
(8) Housing Reform:	• Full funding for HOPE ($2.1 billion in 1992) • 38 percent increase in vouchers • IRA withdrawal for first-home buyers • Enterprise Zones (refundable wage credit, expensing for new stock, zero capital gains rate)
(9) Transportation Infrastructure Investment:	• New highway program (new National Highway System and new block grant) • Major increase in Highway Trust Fund obligations (over $20 billion by 1996) • NASPLAN modernization • Space transportation systems (Shuttle, ASRM, ALS, NASP)
(10) Government Management Reform:	• Budget process reform • Regulatory reform • Accounting systems reform • High-Risk Area targeting • Terminations: 238 programs and 2,591 projects
(11) "States as Laboratories":	• Demonstrations and waivers • Evaluation of natural experiments • $15 billion program turn-over to States (fully funded)

[1] Proposed total governmental spending for 1992 is 2.6 percent greater than 1991 (*i.e.*, growth is less than the inflation rate).

budget proposes funding for major technological advances in high-speed rail and "smart cars/smart highways," which could help relieve the stress on the current system. (See Chapter IV.D.)

- The budget would continue to modernize the national airspace system ("NASPLAN")—increasing funding for Federal Aviation Administration facilities, equipment, and systems by 29 percent, to $2.7 billion.

- Within the budget for space exploration and development, there is funding for the space shuttle, a new advanced solid rocket motor (ASRM), a new advanced launch system (ALS), and a national aerospace plane (NASP). As the use of space becomes increasingly relevant, these essential elements of the space transportation system should be better understood—and funded—as a vital part of America's infrastructure investment. (See Chapter IV.C.)

(10) Governmental Management Reform

Any 1.4 trillion-dollar-per-year enterprise (*e.g.*, the Federal Government) is bound to show signs of failure in one place or another. But the public is demanding; and respect for governmental performance remains understandably low. There is much room for management improvement.

Discontent with government is often visible (and deemed to be newsworthy). The less glamorous issues of management improvement typically are not. Nonetheless, management reform continues to be advanced:

- *Budget process reform.* The Administration is implementing the important and valuable reforms of the 1990 Budget Agreement—enforceable spending caps, "pay-as-you-go," and credit reform. Beyond these, the Administration continues to seek the line-item veto, joint (not concurrent) budget resolutions, biennial budgeting, and a balanced budget Constitutional amendment. (See Chapter IX.D.)

- *Regulatory reform.* The principles of regulatory reform continue to be advanced through the President's Competitiveness Council and the Office of Information and Regulatory Affairs—and through broader application of Risk Management Budgeting. (See Chapter IX.C.)

- *Accounting reform and oversight.* The budget continues to expand its analysis and presentation of "Hidden Liabilities." (See Chapter VIII.) The Administration is implementing the new Chief Financial Officers legislation—improving accounting standards, financial reporting systems, and audits. The budget explicitly identifies High-Risk Areas of vulnerability to fraud, waste, and abuse. And, as appropriate, the Administration is engaging special teams in the effort to reduce these vulnerabilities. (See Chapter IX.A.)

- *Reducing waste and improving returns on investment.* This is not only a problem of accountancy and oversight, as suggested above. It is also a problem requiring greater program evaluation and a willingness to terminate outdated or ineffective programs and projects. (See Chapter IX.B.) The problem, however, goes beyond conventional matters of accounting and evaluation—as discussed further below.

PROGRAM LIFE-CYCLES—AND STATES AS LABORATORIES

Clearly, the government has a need and a responsibility to improve the return on investment of Federal dollars. And improved accounting, analysis, and evaluation have an important role to play in this effort. But beyond these rather technical issues, there are larger structural issues that also require attention.

Fortunately, the 1990 Budget Act creates a framework that can encourage a more basic reform perspective.

The discussion of Entitlement Reform (above) has highlighted the budgetary "takeover" by mandatory programs—and the tendency of such programs increasingly to benefit the non-poor. The pay-as-you-go reforms may serve not only to restrain the further expansion of "mandatories." They should also encourage greater anti-poverty efficiency in the design of such programs.

With respect to discretionary programs, the effect of budget process reforms may be an even more direct increase in attention to pro-

gram efficiency, effectiveness, and return on investment. This should be a natural outgrowth of the existence of fixed, enforceable caps on discretionary spending. With unequivocal limits on available resources, competition on the merits should increase.

As one begins to think about returns on investment, it is perhaps interesting to consider how much Federal spending might be considered "investment" at all. This question involves highly arguable definitional issues.

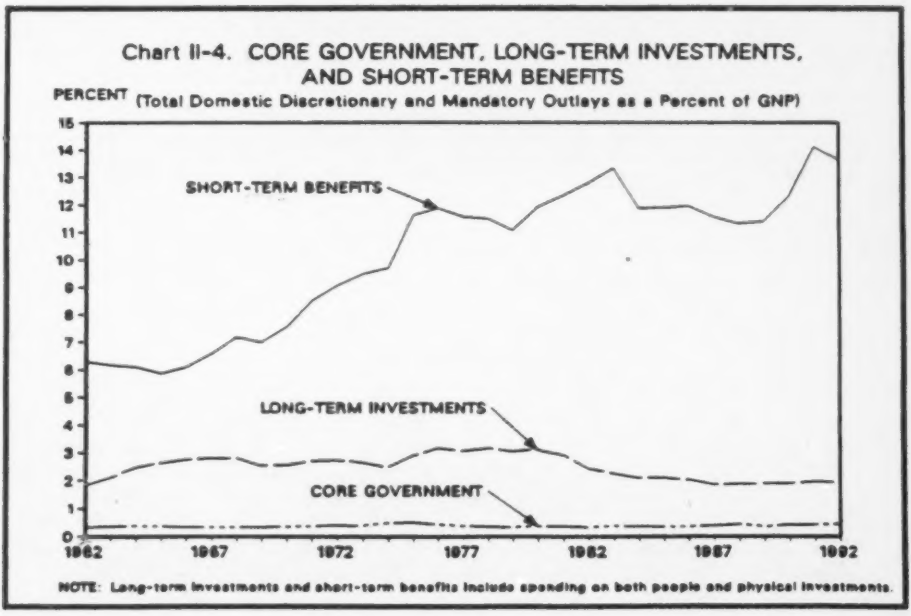
If one puts defense aside, and looks at how much nondefense spending is oriented toward longer-term investment (returns accruing over a period greater than five years), one finds that expenditures for short-term benefits clearly dominate. Long-term investments have been declining as a percent of GNP. (See Chart II–4.) This is, in part, a reflection of the budgetary "takeover" by transfer payments to individuals ("mandatories").

But even if one focuses only on domestic discretionary programs (*i.e.*, excluding mandatories), one finds that longer-term investments have been decreasing as a share of domestic discretionary spending. (See Chart II–5.) The President's budget seeks to correct this trend by increasing investment in R&D, prevention, early childhood, and transportation infrastructure—areas with higher return.

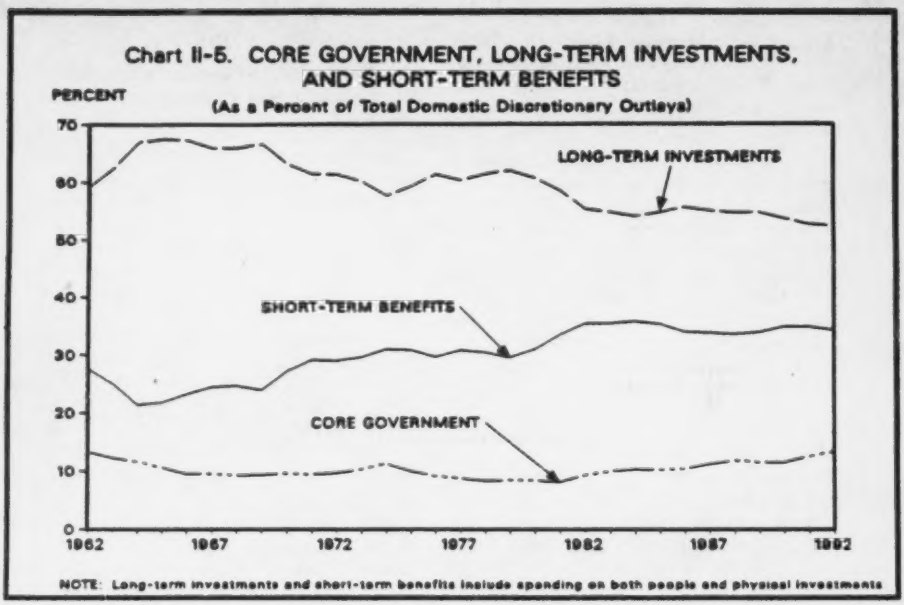
The expectation of a possible shift toward investment in programs with higher return may, of course, prove to be no more than a request and a hope. The existing domestic discretionary program structure has, to date, proven to be rather rigid. Reform will require a new flexibility and a new dynamic.

In the past, domestic discretionary programs often came into existence to address one alleged "urgent priority" or another. The urgency may have derived from a transitory emergency, a desire for "demonstration," or a perceived need for Federal leadership in areas where States and localities were slow to recognize or accept responsibility. As an abstract matter, this rationale may have been legitimate.

Chart II-4. CORE GOVERNMENT, LONG-TERM INVESTMENTS, AND SHORT-TERM BENEFITS



NOTE: Long-term investments and short-term benefits include spending on both people and physical investments.



Once in existence, however, programs have tended to become fixtures in the budget. There is, in practice, little evidence of a program life-cycle—other than a move toward immortality.

In a world of fixed spending caps, there will be no room for emerging priorities if the programs-of-old remain immortal. To allow adaptation to shifting priorities, there will have to be a more dynamic concept of program life-cycles:

- Some programs and projects will have to die. This should be the case, for example, when a program (whether demonstration or not) has proven a failure, or when the urgency of a past priority has been overtaken by events. It should also be the case when a demonstration has proven a success and is, therefore, available for replication and funding through other sources. In applying these principles, this *budget proposes the outright termination of 238 specific domestic discretionary programs and 3,591 specific projects.* These terminations would save $4.6 billion in budget authority in 1992. (See Chapter IX.B.)

- Some programs should decline. This should be the case when their relative priority is judged to have decreased. This budget proposes *declines of $8.3 billion in budget authority from an additional 109 domestic discretionary programs.* These programs were funded at a total of $27.4 billion in 1991. Reasons for proposed reductions are presented in Chapter IX.B.

- Some programs should increase. The reductions and terminations noted above help finance program increases in areas judged to merit higher priority or improved return on investment. *250 domestic discretionary programs are specifically recommended for increases totaling $17.8 billion.* (See Table B–6 in Chapter IX.B and the associated detail in Chapter XIII.)

- Some programs should be consolidated and turned over to the States—funded in more flexible form. Programs appropriate for such turnover may be selected from two

broad categories: those whose purposes are judged by States to be of continuing value, but whose relative funding priority at the Federal level is declining; and those which seem, in any case, to be appropriate for flexible management by the States.

The President has established a target of $15 billion in program turnovers for the States. A list of possible turnover candidates totaling over $20 billion is at Table II–9. The actual selection of programs for turnover would have to be authorized by the Congress—in consultation with the Administration and the Governors. (After the actual selection is determined, the current distribution of such programs by State would be calculated. The Administration would then propose to replace these programs with a single consolidated block grant to the States. The formula for this new block grant would approximate the same distribution to the individual States as they would receive under the present program structure—seeking to assure that no State would be harmed by the move to a new, consolidated block grant.)

The value of this turn-over approach is as follows. It allows the Federal Government to reduce overhead. It allows States to manage a pool of financial resources more flexibly. It moves power and decisionmaking closer to the people. And it reenforces another reformist theme of this Administration: appreciation and encouragement of "States as Laboratories."

This last point is especially important. The American Federal system has within it an enormous power for innovation: the natural variation and experimentation among the States. For too long, this potential has been under-appreciated at the Federal level. Nonetheless, the reality is that some of the most interesting examples of innovation are being set by the States—in areas ranging from educational choice, to enterprise zones, to health cost control, welfare reform, and transportation finance. (See Chapter VI.)

The Administration seeks to reenforce this natural power of the States—and to help build upon it.

In sum, the opportunities for constructive reform are many. (See Table II–5.) Incentives for choice, innovation, and improved performance can be advanced in education. Investment in path-breaking R&D can be increased. The financial service sector can be modernized. Tax incentives for saving and long-term investment can be strengthened. The budgetary "takeover" by "mandatory" programs can be slowed; and the benefits of entitlements can be better targeted for the needy. The problems of the health system can be alleviataed, to some degree, by physician payment reform, malpractice reform, and an emphasis on prevention. The National Drug Control Strategy can be carried forward aggressively to its next stage. The approach to housing can be improved by greater emphasis on choice, homeownership, and Enterprise Zones. Stresses on the transportation infrastructure can be relieved. And the government itself can be managed better—through budget process reform, accounting reform, program evaluation, regulatory reform, and reenforcement of the innovative power of "States as laboratories."

These reforms can all be accommodated within the "flexible freeze" (with total spending growing at less than the inflation rate) and within the limits of the 1990 Budget Act.

If these reform measures are adopted—and assuming satisfactory resolution of the Gulf crisis in the not-too-distant future—the economy can not only return to economic growth. It can move on toward a new record for economic expansion as America advances to the 21st century.

RICHARD DARMAN
DIRECTOR,
OFFICE OF MANAGEMENT AND BUDGET

Table II–6. SPENDING, REVENUE, AND DEFICIT, 1991–1996

(Dollar amounts in billions)[1]

	1991	1992		1993		1994		1995		1996	
	Dollars	Dollars	% Change	Dollars	% Change	Dollars	% Change	Dollars	% Change	Dollars	% Change
Spending:											
Discretionary:											
Defense	307.8	300.4	–2.4	293.3	–2.4	287.6	–1.9	289.2	0.5	293.8	1.6
International	18.7	19.6	4.7	20.4	4.2	21.5	5.1	21.8	1.3	22.0	0.9
Domestic	199.8	212.0	6.1	223.2	5.3	228.9	2.6	231.7	1.2	238.5	2.9
Subtotal, discretionary	526.3	532.1	1.1	536.9	0.9	538.0	0.2	542.7	0.9	554.2	2.1
Mandatory	686.2	707.5	3.1	706.3	–0.3	673.5	–4.5	713.8	6.0	775.6	8.7
Interest	197.0	206.3	4.7	212.0	2.8	215.5	1.6	213.8	–0.8	211.0	–1.3
Total spending	1,409.6	1,445.9	2.6	1,454.2	0.6	1,427.1	–1.9	1,470.3	3.0	1,540.8	4.8
Total revenues	1,091.4	1,165.0	6.7	1,252.7	7.5	1,365.3	9.0	1,467.3	7.5	1,560.7	6.4
Consolidated deficit	318.1	280.9	—	201.5	—	61.8	—	2.9	—	–19.9	—
Memorandum											
Deposit insurance (included above):											
Resolution Trust Corporation	84.6	76.1	—	34.3	—	–47.6	—	–45.7	—	–32.0	—
Bank Insurance Fund	15.9	9.7	—	8.0	—	6.8	—	0.9	—	0.6	—
FSLIC Resolution Fund	11.1	3.3	—	2.8	—	2.2	—	2.7	—	1.5	—
Savings Association Insurance Fund and Other	–*	–1.0	—	–0.8	—	0.4	—	–0.3	—	*	—
Subtotal, Deposit insurance	111.5	88.1	—	44.2	—	–38.1	—	–42.3	—	–29.9	—
Desert Shield (placeholder, included above)	8.2	4.6	—	0.8	—	0.4	—	—	—	—	—
Social Security (included above):											
Operating surplus	40.3	38.7	—	45.3	—	56.6	—	65.5	—	77.2	—
Interest	20.2	23.7	—	28.0	—	32.8	—	38.3	—	44.6	—
Total	60.4	62.4	—	73.3	—	89.3	—	103.9	—	121.8	—

[1]Percent change measures change from previous year.

*$50 million or less.

Table II–7. RECEIPTS MEASURES, 1991–1996

(In millions of dollars)

	1991	1992	1993	1994	1995	1996
Enhance long-term investment[1]	400	3,000	1,700	900	1,800	1,700
Extend HI coverage to State and local employees[2]	—	1,125	1,537	1,545	1,548	1,544
Improve retail compliance with alcohol special occupational taxes[2]	—	43	43	9	9	9
Increase IRS enforcement funding	—	35	133	176	180	184
Extend tax deadlines for Desert Shield (placeholder) participants	−38	21	6	—	—	—
Extend railroad UI reimburseable status[2]	−10	2	10	8	−1	−1
Increase HUD land sales fee	—	*	*	*	*	*
Extend abandoned mine reclamation fees	—	—	—	—	—	260
Extend R&E credit	—	−500	−1,000	−1,300	−1,600	−1,800
Extend R&E allocation rules	—	−346	−264	—	—	—
Establish family savings accounts	—	−300	−800	−1,300	−1,800	−2,300
Extend health insurance deduction for self-employed	—	−120	−239	—	—	—
Extend low-income housing credit	—	−59	−215	−305	−337	−337
Extend targeted jobs credit	—	−56	−100	−64	−29	−20
Establish enterprise zones	—	−50	−160	−310	−520	−750
Waive excise tax for certain early withdrawals from IRAs	—	−50	−70	−100	−110	−110
Extend business energy credits	—	−30	−17	4	2	1
Double and restore adoption deduction	—	—	−3	−3	−3	−3
Extend highway trust fund taxes[2]	—	—	—	—	—	−2,722
Total effect on receipts	352	2,715	561	−740	−861	−4,345
Total effect on receipts with enhance long-term investment at zero	−48	−285	−1,139	−1,640	−2,661	−6,045

* $500,000 or less.

[1] The proposal to enhance long-term investment is shown as estimated by the Treasury Department's Office of Tax Analysis (OTA). Because the methodological differences among OTA, Congressional estimators, and outside experts have not yet been resolved, totals are presented with the Administration's estimate and with a zero (neutral) entry for the proposal.

[2] Net of income tax offsets.

Table II–8. DEFICIT IMPACT OF ADMINISTRATION PAY-AS-YOU-GO PROPOSALS

(In billions of dollars)

	1991	1992	1993	1994	1995	1991–95
Deficit impact of Administration pay-as-you-go proposals:						
Direct spending (see Table II–8)	−0.1	−6.3	−9.3	−9.0	−11.0	−35.8
Receipts:						
Extenders (selected)	*	1.1	1.8	1.7	2.0	6.6
Long-term investment incentive[1]	−0.4	−3.0	−1.7	−0.9	−1.8	−7.8
All other	*	−0.8	−0.6	0.2	0.9	−0.3
Total, receipts	−0.4	−2.7	−0.4	0.9	1.0	−1.5
Total, receipts with long-term investment incentive at zero	*	0.3	1.3	1.8	2.8	6.3
Total, net deficit impact	−0.5	−9.0	−9.8	−8.1	−9.9	−37.3
Total, net deficit impact with long-term investment incentive at zero	−0.1	−6.0	−8.1	−7.2	−8.1	−29.5

* $50 million or less.

[1] The proposal to enhance long-term investment is shown as estimated by the Treasury Department's Office of Tax Analysis (OTA). Because the methodological differences among OTA, Congressional estimators, and outside experts have not yet been resolved, totals are presented with the Administration's estimates and with a zero (neutral) entry for this proposal.

Table II–9. PROPOSED POLICY CHANGES IN MANDATORY PROGRAMS

(Outlays; in millions of dollars)

	1992	1993	1994	1995	1996
Department of Agriculture					
Commodity Credit Corporation: reduce subsidies to those with off-farm income over $125,000	-36	-90	-90	-90	-90
Crop Insurance: increase farmer responsibility for premium payments	-77	-167	-164	-152	-146
Food Safety and Inspection Service: seek reimbursement from industries for certain overtime activities	-50	-50	-50	-50	-50
Food Stamps: effect of increased child support enforcement	—	-10	-20	-30	-34
Miscellaneous User Fees: increase fees for recreation and grain inspection and establish fees for agricultural marketing	-29	-32	-32	-33	-34
Rural Electrification Administration: continue shift from direct to guaranteed loans	-13	-38	-59	-74	-67
Department of Education					
Guaranteed Student Loans: net impact of reducing the number of loans that default by: improving eligibility screening of schools; enhancing procedures for default collection; requiring risk sharing and increasing loan limitations	-102	-173	-229	-282	-289
Department of Energy					
Elk Hills Naval Petroleum Reserve: lease production rights	-1,191	139	120	113	95
Power Marketing Administrations: revise the level and schedule of the PMAs' debt repayments to the Federal Government	-377	-382	-406	-417	-402
Strategic Petroleum Reserve: delay required purchase of petroleum until 1992 and 1993[1]	36	86	—	—	—
Department of Health and Human Services					
Family Support: improve the child support enforcement system	-120	-129	-142	-163	-179
Foster Care: limit the Federal Government's payment of administrative costs to only those required to provide benefits to low-income children	-210	-290	-352	-405	-452
Medicaid: net impact of allowing States to expand medically-needy eligibility for pregnant women and children; strengthening medical child support enforcement; and the impact of Medicare proposals	25	75	75	90	95
Medicare:					
Clinical Labs:					
Apply 2% update for 1992 and 1993, only for those below payment caps	-20	-50	-70	-80	-90
Restore 20% co-insurance, identical to all other Part B services	-450	-800	-900	-1,020	-1,160
Subtotal, clinical labs	-470	-850	-970	-1,100	-1,250
Coordinated Care Initiative: Begin a Medicare coordinated care initiative whose costs would be largely offset by: applying home health limits by discipline and establishing a uniform disabled/ESRD secondary payor threshold	-130	25	40	70	195

[1]The SPR proposal saves $123 million in outlays for 1991.

Table II–9. PROPOSED POLICY CHANGES IN MANDATORY PROGRAMS—Continued

(Outlays; in millions of dollars)

	1992	1993	1994	1995	1996
Durable Medical Equipment (DME):					
Adjust enteral/parenteral fee schedule	-10	-15	-15	-15	-15
Refine DME/oxygen payment methods, in part to reflect increased use of less-expensive oxygen delivery services	-35	-85	-105	-130	-135
Subtotal, medical equipment	-45	-100	-120	-145	-150
High-Income Beneficiaries: Reduce Federal Medicare subsidy for high-income beneficiaries (over $125,000 AGI)	-41	-169	-245	-323	-426
Hospitals:					
Adjust indirect medical education add-on payment factor from 7.65% to 4.4% in 1992, phasing down to 3.2% in 1996	-1,045	-1,385	-1,705	-2,080	-2,500
Eliminate duplicate payments for hospital-based nonphysician practitioners by adjusting hospital payment update factor	-10	-10	-10	-10	-10
Include payment for certain post-hospital services in Medicare hospital payment	-30	-40	-50	-50	-60
Limit graduate medical education per-resident payment, and encourage training of primary care physicians	-140	-160	-190	-230	-260
Place Medicare hospital update on a January 1 cycle	-670	-930	-1,320	-1,450	-1,540
Subtotal, hospitals	-1,895	-2,525	-3,275	-3,820	-4,370
Outpatient Departments (OPDs): Pay a uniform rate for outpatient services, whether performed in doctors' offices or OPDs	-50	-100	-125	-150	-175
Physicians:					
Eliminate double payment for physician collection of lab specimens	-10	-20	-20	-20	-25
Establish a single fee for anesthesia services	-80	-150	-170	-200	-230
Establish a single fee for assistants at surgery	-50	-80	-90	-100	-110
Revise 1991 Medicare volume performance standard to correct error	—	-90	-150	-190	-220
Revise Medicare economic index to reflect better data and new methodology	-30	—	—	—	—
Use efficient rate for radiology and diagnostic tests	—	-10	-15	-20	-20
Subtotal, physicians	-170	-350	-445	-530	-605
Other:					
Effect of Medicare proposals on HI premiums	17	20	26	30	33
Eliminate return-on-equity payments for proprietary skilled nursing facilities	-50	-70	-60	-60	-70
Establish a uniform payment policy for medicare covered drugs	-10	-30	-30	-40	-40
Recalculate payments for physical and respiratory therapy, based on newer data	-10	-10	-15	-15	-20
Subtotal, other	-53	-90	-79	-85	-97
Subtotal, Medicare	-2,854	-4,159	-5,219	-6,083	-6,878
Supplemental Security Income: collect SSI over-payments and charge States certain administrative fees	-96	-159	-250	-250	-240

Table II–9. PROPOSED POLICY CHANGES IN MANDATORY PROGRAMS—Continued

(Outlays; in millions of dollars)

	1992	1993	1994	1995	1996
Department of Housing and Urban Development					
Federal Housing Administration: reduce FHA multifamily insurance claims through: improved underwriting, monitoring, and servicing; removal of legislative restraints on defaulted property sales; and the proposed Low-Income Resident Economic Empowerment program	-564	-1,062	-1,024	-860	-1,269
Government National Mortgage Association: exempt GNMA from VA's formula for acquiring foreclosed property producing savings for VA-guaranteed loans acquired by GNMA	-45	-38	-25	-20	-19
Department of the Interior					
Arctic National Wildlife Refuge: lease oil and gas exploration rights	—	-1,901	-1	-1,201	-1
Department of Labor					
Trade Adjustment Assistance: repeal TAA benefits for workers unemployed due to competition from imports	-114	-193	-204	-200	-194
Department of Treasury					
Coinage Profit Fund: finance numismatic and bullion coin operations for the United States Mint	-94	—	—	—	—
Department of Veterans Affairs					
Veterans Compensation and Pension: standardize Dependency and Indemnity Compensation payments; increase pension eligibility requirements and extend several expiring provisions of OBRA	-17	-433	-391	-354	-320
Veterans Home Loans: raise fee and require down payment for multiple use of loan guaranty benefit; improve formula used to acquire foreclosed property and extend expiring OBRA fee increase	-308	-242	-202	-178	-160
Veterans Readjustment Benefits: target eligibility for vocational rehabilitation to veterans with higher rated disabilities and eliminate step-children from eligibility for training and education benefits	-12	-32	-31	-31	-31
Veterans Third Party Medical Recoveries: extend several expiring provisions of OBRA	—	—	-225	-255	-274
Environmental Protection Agency					
Pesticide Reregistration Fee: remove existing cap on amount that may be collected from any one registrant	-3	-3	-3	-3	-3
Other Agencies					
Corps of Engineers: expand existing user fees for day use of developed recreational sites	-20	-20	-20	-20	-20
Postal Service: require the Postal Service to pay a larger share of the costs for health benefits and cost-of-living adjustments for post-1971 retired postal employees and their survivors	-198	-198	-198	-198	-198
Railroad Retirement Board: reflects net impact of conforming rail security benefits with social security benefits and requiring the rail pension to finance 25% of the windfall benefits	145	142	141	139	137
Other	8	15	17	20	24
Total, outlay savings	-6,316	-9,344	-8,984	-10,987	-10,999

Table II–10. POTENTIAL BLOCK GRANT PROGRAMS
(In millions of dollars)

Department/Program	Enacted		Proposed									
	1991		1992		1993		1994		1995		1996	
	BA	O	BA	O	BA	O	BA	O	BA	O	BA	O
Education:												
Impact aid payments	781	815	620	666	620	651	620	624	620	620	620	620
Supplemental education opportunity grants	520	404	347	498	347	352	347	347	347	347	347	347
Chapter 2 block grant	449	533	449	465	449	445	449	449	449	449	449	449
Public library services programs	143	155	35	115	35	71	35	35	35	35	35	35
Environmental Protection Agency:												
Construction grants	2,083	2,345	1,900	2,195	1,200	2,082	600	1,883	—	1,482	—	1,025
Health and Human Services:												
State welfare administrative expenses for Medicaid, AFDC, and Food Stamps	5,178	5,167	5,878	5,867	6,453	6,440	7,062	7,048	7,701	7,686	8,366	8,349
Social services block grant	2,800	2,800	2,800	2,800	2,800	2,800	2,800	2,800	2,800	2,800	2,800	2,800
Low-income home energy assistance program	1,610	1,669	1,025	991	875	796	625	552	475	393	375	287
Housing and Urban Development:												
Selected public and subsidized housing programs	5,512	3,185	4,789	3,805	4,837	4,484	4,897	4,685	4,961	5,036	5,026	4,968
Community development block grants	3,200	3,073	2,920	3,097	2,920	3,061	2,920	2,906	2,920	2,914	2,920	2,915
Justice:												
Byrne Memorial State and local law enforcement assistance program	490	342	490	421	490	475	490	481	490	484	490	491
Total	22,766	20,488	21,253	20,949	21,026	21,657	20,845	21,810	20,798	22,246	21,428	22,286

Table II–11. PROPOSED OUTLAYS, BY AGENCY

(In billions of dollars)

Agency	1991[1]			1992		
	Discretionary	Mandatory	Total	Discretionary	Mandatory	Total
Cabinet Agencies:						
Agriculture	11.6	43.9	55.4	12.5	43.2	55.7
Commerce	2.9	–0.1	2.8	2.9	–0.1	2.8
Defense—Civil	3.4	23.0	26.4	3.5	24.7	28.2
Defense—Military	288.3	–0.8	287.5	283.8	–0.7	283.0
Education	18.8	6.1	24.8	20.5	7.0	27.5
Energy	16.0	–2.4	13.5	17.4	–2.5	14.9
Health and Human Services	27.8	458.4	486.3	28.7	496.6	525.3
Housing and Urban Development	21.8	1.7	23.5	23.4	0.9	24.3
Interior	6.6	–0.2	6.4	6.7	–0.2	6.5
Justice	7.7	1.0	8.7	9.0	1.0	10.0
Labor	8.8	25.7	34.5	9.2	25.5	34.8
State	4.0	0.3	4.3	4.2	0.3	4.5
Transportation	30.5	0.2	30.8	31.6	0.3	31.9
Treasury	8.8	268.3	277.1	9.6	289.0	298.6
Veterans Affairs	13.9	17.5	31.3	14.7	18.1	32.8
Major Agencies:						
Deposit Insurance Accounts	0.1	111.4	111.5	—	88.1	88.1
Environmental Protection Agency	5.9	–0.1	5.8	6.1	–0.2	5.9
General Services Administration	0.9	–0.1	0.8	0.9	–0.1	0.7
National Aeronautics and Space Administration	13.5	—	13.5	14.7	—	14.7
Office of Personnel Management	0.2	35.0	35.2	0.2	36.8	37.0
Small Business Administration	0.5	—	0.5	0.5	–0.2	0.3
Other Agencies:						
Executive Office of the President	0.3	—	0.3	0.3	—	0.3
Funds Appropriated to the President	11.8	–0.5	11.3	12.7	–0.7	12.0
Judicial Branch	1.9	0.2	2.1	2.2	0.1	2.3
Legislative Branch	2.2	0.3	2.5	2.6	0.4	3.0
Other Independent Agencies	10.3	4.0	14.2	9.4	4.6	14.0
Allowances	8.2	—	8.2	4.7	—	4.7
Undistributed offsetting receipts	—	–109.4	–109.4	—	–118.0	–118.0
Total Outlays	526.3	883.3	1,409.6	532.1	913.8	1,445.9

[1] Includes impact of supplementals and rescissions.

Table II–12. DISCRETIONARY PROPOSALS, BY APPROPRIATIONS SUBCOMMITTEES

(In millions of dollars)

Appropriations Subcommittee	1991 Enacted		1991 Proposed		1992 Proposed		1992 Proposed Less 1991 Enacted	
	BA	Outlays	BA	Outlays	BA	Outlays	BA	Outlays
Domestic Discretionary								
Commerce, Justice, State and Judiciary	13,941	14,311	13,981	14,339	15,686	15,927	1,745	1,616
District of Columbia	568	575	568	575	536	536	–32	–39
Energy and Water	9,062	8,807	9,062	8,807	9,830	9,132	768	325
Interior	12,758	11,816	12,758	11,816	12,068	12,214	–690	398
Labor, HHS, and Education	55,972	54,074	56,197	54,269	56,003	57,352	31	3,278
Legislative Branch	2,158	2,165	2,158	2,165	2,664	2,597	506	432
Rural Development, Agriculture, and Related Agencies	8,845	8,901	8,858	8,914	10,204	9,674	1,360	773
Transportation	12,498	29,842	12,498	29,842	14,560	31,067	2,062	1,225
Treasury, Postal Service and General Government	11,872	10,772	11,872	10,772	10,807	11,241	–1,065	469
Veterans Affairs, HUD, and Independent Agencies	60,265	58,549	60,198	58,516	64,914	62,195	4,649	3,646
Allowances	—	—	—	—	97	97	97	97
Total Domestic Discretionary	187,939	189,612	186,147	199,814	197,370	212,032	9,431	12,419
Defense Discretionary								
Defense	268,994	281,393	265,681	280,611	270,866	275,474	1,872	–5,919
Energy and Water, Function 050	10,955	10,355	11,578	10,513	11,780	11,443	825	1,089
Military Construction	8,410	7,939	8,290	7,928	8,143	8,366	–267	427
Commerce, Justice, State and Judiciary	225	166	225	166	225	178	—	12
Veterans Affairs, HUD and Independent Agencies	335	336	335	336	337	339	3	2
Total Defense Discretionary	288,919	300,189	286,109	299,554	291,351	295,800	2,432	–4,389
Allowance for Desert Shield (placeholder)	—	—	14,000	8,200	—	4,611	—	4,611
Total Defense Discretionary with Allowance for Desert Shield (placeholder)	288,919	300,189	300,109	307,754	291,351	300,411	2,432	222
International Discretionary								
Commerce, Justice, State, and Judiciary	4,279	4,632	4,379	4,715	5,402	4,906	1,123	274
Foreign Operations	14,869	12,855	14,730	12,897	27,311	13,578	12,441	723
Labor, HHS and Education	8	9	8	9	9	9	1	—
Rural Development, Agriculture, and Related Agencies	981	1,097	1,011	1,120	1,301	1,120	320	23
Total International Discretionary	20,137	18,593	20,129	18,740	34,022	19,613	13,885	1,021
Total Discretionary	496,995	518,394	508,385	526,308	522,744	532,056	25,749	13,662

CONSIDERATION OF THE ECONOMIC OUTLOOK AND THE FISCAL YEAR 1992 BUDGET

WEDNESDAY, FEBRUARY 6, 1991

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:08 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Jim Sasser (chairman of the committee) presiding.

Present: Senators Sasser, Riegle, Exon, Lautenberg, Sanford, Wirth, Fowler, Conrad, Domenici, Symms, Grassley, Kasten, Nickles, Gramm, Bond, Lott, and Brown.

Staff present: Larry Stein, staff director; John J. Callahan, deputy staff director; and Gordon Stoddard, assistant director and counsel for economic affairs.

For the minority: G. William Hoagland, staff director; and Peter Taylor, chief economist.

OPENING STATEMENT OF CHAIRMAN SASSER

Chairman SASSER. The committee will come to order this morning.

Let me announce at the outset that we have adopted in the committee an early-bird rule. There was some discussion on both sides yesterday with regard to that, and the suggestion has been made strongly from a couple of quarters—and I agreed with it—that we ought to adopt the early-bird rule as of the time the committee is supposed to convene. And those Senators who are here at the time of convening will be recognized in order of seniority, and thereafter there will be a strict early-bird rule. So, without objection, that will be the course we will follow this morning and hereafter.

Senator BOND. Mr. Chairman, I might ask, since we had some problems yesterday with ending the questioning in 5 minutes, for those of us who waited—I came after a banking hearing yesterday, and I think I got my first questions about quarter to 1:00—if we stick to the 5-minute schedule. Some of the people went as much as 10 minutes on the first round. I think that we all ought to try to abide by the five-minute limitation, and I would urge you to consider using the gavel when the red light goes off.

Chairman SASSER. I thank you, Senator Bond, and I think that is a point well made. Yesterday I felt that some Senators did go over unduly. The Chair hesitates to cut off a Senator or a witness in the middle of a question or in the middle of an answer. So I think we must apply a rule of reason to that. But I think your suggestion is

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well taken, and I would urge all Senators to try to observe the red light that we have set there on the witness table, and I would ask the witnesses, if at all possible, to try to shorten your answers so that you don't run over the red light for any considerable period of time.

I want to welcome the distinguished Secretary of the Treasury, Nicholas Brady, before us this morning. It is always a pleasure for me to have Senator—Secretary Brady before our committee. A Freudian slip. I called him "Senator Brady." He was a valued and very able member of this body for a number of years, and it is always a pleasure to have him back.

We also welcome this morning the distinguished Chairman of the Council of Economic Advisers for the President, Dr. Michael Boskin.

I would like to say to our witnesses this morning that at 10:30 I am going to have to leave briefly to appear before another committee to introduce one of my fellow Tennesseeans who is being considered for Secretary of Education. My short absence will not indicate any lack of interest in what the witnesses have to say today. That is an absence of necessity.

We are all eager this morning to hear the views of our distinguished witnesses relative to the economy, relative to the condition of the banking industry, and to the budget. I am pleased to see this morning that the very able chairman of the Banking Committee, Senator Riegle, is here. He is also a valued member of the Budget Committee.

The President's budget for fiscal year 1992 is now 2 days old officially, and this budget is really the first offspring of the 5-year deficit reduction agreement that we struggled so hard to achieve last year. At first glance, it is clear to see that this budget is indeed the offspring of that 5-year budget agreement because the resemblances are striking and marked.

I think this proposed budget carries forward the mission of cutting nearly $500 billion off the deficit by fiscal year 1995. Now, that is the good news. However, I there is a large piece of bad news looming, and that is the economic cloud that hovers over this budget, and that is the recession that we are in at the present time.

Some say, particularly academic economists, that this recession will be mild and short-lived. I very much hope they are correct. But in my discussions with business people, bankers, others who are down where the rubber meets the road, there is apprehension that this recession may prove more severe than we are anticipating.

Already more than 1 million Americans have lost their jobs since last June. Two-thirds of all of the jobless Americans do not receive unemployment benefits as of today.

And for the first time since the Great Depression—this is very disturbing, I think, to all of us—we are entering this recession with our banking system in a very weakened condition. Banks are very reluctant to extend credit to businesses, and everyone from the President of the United States on down fears that the credit crunch that we are experiencing will prolong this recession.

Indeed, we learned that bank insurance fund, or, as I have always known it, the Federal Deposit Insurance Corporation, is

projected to become insolvent next year. The lack of resources for the Federal Deposit Insurance Corporation creates a cloud over our whole financial sector, and I think that cloud makes it even more difficult for us to pull out of this downturn.

Secretary Brady, the report that you sent to Congress yesterday is a thoughtful and comprehensive report, and we thank you for it. But I must say that it does not directly address the insolvency of the insurance fund. Likewise, the President's budget assumes enormous expenditures on bank resolutions over the next few years. But it also does not tell us how they will be paid for.

This is an issue that must be faced squarely. We are already spending far too much on the savings and loan crisis, and I think that is a result of not facing this issue early and squarely. I think the taxpayers need to know what their exposure is. If there is going to be Treasury borrowing, we need to know how soon and how fast the banks are going to pay it back. And because banks must make loans to move us out of the recession, we should start on this sooner rather than later. I think we have learned our lesson that bad news doesn't get better with age. It simply gets worse. And we learned that in the S&L crisis.

Dr. Boskin, I might say that I noted your comments yesterday, and I was very heartened to hear your prediction of a short, mild recession, and I pray that you are correct in that prediction. But when it comes to economic forecasting, somehow I find that my doubts are more correct than my hopes are. At least, that has been my experience over the last few years.

We all want prosperity, but we have an obligation, I think, to help those who are harmed by the recession.

The administration's budget presents no antirecession initiatives for working Americans or for their families. For these people, a recession is very meaningful. It means not just a smaller bonus. It means not just a postponed vacation. But it means no jobs. It means no support for a family. It means no way to pay the mortgage, no way to pay the rent.

The help these people deserve is just not here. I fear that the budget that we are contemplating simply wishes the recession away, and we have no programs or ideas advanced as to how to deal with it.

It offers no extended benefit program for those unemployed longer than 26 weeks. It underfunds the cost of running the unemployment insurance program. It cuts worker training and employment programs.

In short, I believe the budget can be improved if the administration will work with the Congress to fashion policies that shore up our financial system and that will combat the growing recession that so many Americans rightfully fear.

Having said that, I will now turn to the distinguished ranking member, Senator Domenici, for any opening statements, comments, or observations he might wish to make at this time. Senator Domenici?

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Mr. Chairman, thank you very much.

Fellow members of the Budget Committee, it is good that we start our second official day of hearings, and I am very hopeful, as the chairman is, that we will move with dispatch this year in our budget deliberations.

I welcome both of you to this committee, and, Secretary Brady, knowing of your genuine close relationship with President Bush and your commitment to this country and the enormous job you have as the Secretary of the Treasury, I want to, in a sense, compliment the President through you today. I think the American people ought to know that we talk a lot up here and a lot of people are saying where are the President's domestic proposals and where are his ideas, as if you can just pull them out of the hat and they will all be ready.

I want to recall for the Senators here and for those interested that we just got a budget and it was on time. Some don't like it, but it clearly is a very good budget in terms of forcing us to make some choices. And I really believe that is why we are elected. So I am very pleased. I think we ought to talk about it, not talk about Wonderland but, rather, within the agreement what can we do and what can't we do.

The President has already sent us a full proposal on drugs. Not two sentences, a full proposal. If we don't like it, fine. But let's debate it. Let's get on with the business. Frankly, everything he sends up is not to my liking, but I do believe that with people like you around him, Secretary Brady, things are moving, and I am very pleased and proud to try to be helpful.

Now, yesterday, through the Department that you head as Secretary of the Treasury, you sent the most far-reaching proposals with reference to the banking system that we have had since the Great Depression. Years ago we set in motion some of the things that are still there that have kept this country and its financial system part of this great economic vitality of America. It is not easy to put that proposal together, and I predict here today, fresh off the press, there will be people saying what is wrong with it. That is fine.

But I think, Mr. Chairman—and now I speak to the chairman of the Banking Committee—we ought to get on with it. Before the year is out, we ought to decide whether the banking system needs modernizing or not, whether it needs more money or not. That is why we are here, and that is why Secretary Brady is where he is.

Now, let me just close my remarks by saying next week, for those who want to hear policy proposals, we will get a full energy policy. I say to my friend from Texas, it will be delivered. I don't know if you will like it; I don't know if I will like it. The President and his people will send it up here, and we will have a lot of choices. And downstairs we are approving a new Secretary of Education. Our chairman just alluded to it. He will very quickly build on the proposals that are in the budget. And next week Secretary Skinner will send us a comprehensive transportation plan. So this ought to be a busy year, and I don't think we can fault the administration and the President with reference to having a domestic agenda.

Now, I say to both of you, my friend the chairman speaks of things that we might look at to help those who are suffering because of the current recession, and clearly we ought to look at

those things. But I believe our principal role is to see what we can do to get America's economic prosperity machine going again. I think the important thing for this country is to have the economy growing. We never appreciate that so much as when it is not growing. Then we say let's do something. We happen to have had growth for a longer period of time than usual.

And, Mr. Boskin, I compliment you for the economic assumptions. They are not pie in the sky. It seems to me you have been modest in your assumptions, and I hope you are right that the recession is short-lived.

I would like to know today if both of you feel that the President has proposed everything that he could to turn the economic machine around and have it grow again. Are there some things we ought to be looking at that will build prosperity opportunities that are not in it that maybe belong in it?

Thank you, Mr. Chairman. It is a pleasure having our two administration witnesses here and having this hearing. It is a pleasure for me to be here. Thank you.

Chairman SASSER. Thank you very much, Senator Domenici.

Mr. Secretary, I know that you have devoted considerable thought to the banking proposals and plans that you are bringing before the Congress, and so we are looking forward this morning to hearing your testimony on that particular subject and others. If you would go forward, we would appreciate it.

STATEMENT OF NICHOLAS F. BRADY, SECRETARY OF THE TREASURY

Secretary BRADY. Thank you, Mr. Chairman, Senator Domenici, members of the committee. I am pleased to meet with you this morning to discuss President Bush's 1992 budget and other issues. My comments will concentrate on certain pieces of the budget, and Mike Boskin will follow with his comments and review the economic forecast.

We meet at a difficult time. We are at war in the gulf, the economy is in recession, and problems inherited from the past continue to occupy our attention. We cannot shirk our responsibility to make Government a positive and effective force in dealing with the current problems that we are expected to address, while at the same time investing in America's future.

Although economic and budget realities constrain our actions, I believe that this budget achieves the goals of meeting our ongoing responsibilities, addressing problems inherited from the past, and building a base for future economic growth and international competitiveness.

The need to restrain Government spending and abide by the terms of the budget agreement are an overarching concern. Over the next 5 years, the Federal Government will borrow in the credit markets a half a trillion dollars less, $500 billion, than it would have borrowed in the absence of the budget agreement. Although a sharp rise in the near-term deficits may obscure our efforts, there is widespread consensus that this budget agreement is an effective effort to deal with the deficit.

Furthermore, important budget process reforms were adopted to insure that the deficit reduction targets are met. These process reforms are an integral part of the agreement, and it is essential that both the letter and the spirit of these reforms are kept.

President Bush's budget, which increases spending less than inflation, represents a strong commitment to reducing future deficits. Deficits have a corrosive effect on economic activity. They crowd private borrowers out of financial markets, and they represent a large diversion of our national savings away from investment in new plant, research and development, and other uses which would directly enhance productivity and competitiveness and create economic growth. In short, deficits make it more difficult to manage our macroeconomic affairs, and ultimately they reduce our economy's growth potential.

Our 1992 budget priorities have been set to keep future budget deficits on a downward path. Our plans for dealing with current problems, as well as the need to improve economic growth and prepare our economy for the international challenges of the future, have been shaped by this necessity. Given the overall budgetary constraint, this necessarily requires a reordering of our priorities.

Although the pressure to deal with contemporaneous demands is always great, the Bush administration believes that we must also look to the future. Toward this end, we have made a number of proposals for addressing the economy's long-term growth potential.

Since productivity is the critical element in the long-term well-being of the American economy and the key to our international competitiveness, it must be a central focus of our attention. Although many factors affect productivity, three of the most important are education, investment, and technology. As I will discuss later, this budget addresses all three, as well as other elements.

Of course, the long run cannot begin until we get past the short run. In the near term, there are several uncertainties that affect our budgetary situation. The most important are the depth and duration of the recession and the length of the war in the gulf.

A further uncertainty is the unpredictable course of the S&L cleanup. The RTC has moved aggressively to deal with this problem, and progress has already been made. Quick action by Congress on funding, combined with lower interest rates and an early end to the recession, will help us continue to move ahead on this problem.

The administration anticipates a recovery from the recession beginning by midyear and a brisker upturn in the latter part of the year, which should bring the unemployment rate down and put us back on a growth track.

President Bush's budget sets an important marker which we believe must be adhered to—namely, to hold spending growth below the rate of inflation. In other words, the real level of spending must come down. The reason is simple: Spending growth is what has fueled the deficit. Unless we can hold the level of spending below the inflation rate, we cannot hope to make the kind of progress on reducing the deficit which the American people expect of us.

To fulfill our responsibility to the economy and make good on the promises made in last year's budget agreement, it is essential that we get the deficit down by controlling spending. As we all know, it

won't be easy. We have already done a good deal of the hard first step, and economic recovery could do a lot of the rest.

Within the context of spending restraint and deficit reduction, this budget shows there is still room for action and initiative. We have just put forward a comprehensive plan for fundamental reform of the banking system. Such a reform is necessary to build capital in the banking industry, protect taxpayers and depositors, and remove old restrictions on banking activities. Our goal is to provide the American people with the best quality financial services available and to provide the banks with the tools to meet the challenge of the future and of international competition. I have appended a summary of our reform proposals to my testimony.[1]

In addition, the President has proposed extension of the targeted jobs tax credit to help deal with the problem of unemployment among the economically disadvantaged, and extension of the low-income housing credit to encourage private construction of low-income housing. We are also asking for extension of the solar and geothermal energy credits to encourage investment in renewable energy technologies.

Together, these proposals address some of the issues facing us today—problems of financial institutions, unemployment, housing and energy. However, as I mentioned earlier, we also have a responsibility to deal with the longer term. Toward this end, President Bush has put forward in this budget initiatives to improve our Nation's educational system by providing opportunities for individual choice, and to improve and expand our Nation's transportation system. In addition, we are asking Congress to support the following initiatives designed to induce long-term economic growth and competitiveness:

First, family savings accounts. Increasing national saving is critical to providing the capital our economy will need to modernize and expand its productive capacity. We believe that providing individuals with a new savings vehicle will help stimulate such saving.

Second, a permanent research and experimentation credit. Research and experimentation are essential to innovation and growth. We all know that. We believe that the R&E tax credit is an effective method of promoting private research and development. But it needs to be enacted permanently if we are to derive its maximum effect.

Third, enterprise zones. The problems of the inner city and rural areas demand a new approach. We believe that enterprise zones can be an effective method of targeting private resources to areas that are experiencing economic distress.

Fourth, permit withdrawals from IRA's for first-time home buyers. Owning a home is part of the American dream, but many younger people increasingly find it beyond their reach. We believe that permitting penalty-free withdrawals from IRA's for first-time buyers will not only bring home ownership within the means of more people, but also provide a greater incentive for younger people to open and contribute to IRA's.

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[1] See p. 229.

Fifth, a capital gains tax differential. We believe that entrepreneurial activity is the engine that drives the economy in the long run, creating new inventions, products and services that sustain growth. That is why a reduction in the capital gains tax is important. In this regard, we are hopeful that Chairman Greenspan, working with Congress and the administration, can illuminate and help resolve the disagreements surrounding this issue.

We believe that these incentives will help achieve our economy's long-term growth potential and provide the tools to meet the competitive challenges of the future.

In closing, I would like to turn briefly to the international sphere. It is increasingly clear that we live in an integrated world economy and that the economic health of other nations is essential to our own. The budget reflects this. Funding is provided for President Bush's Enterprise for the Americas Initiative, to help improve trade and investment for our neighbors in the Western Hemisphere. We are also lending a helping hand for economic reform in Eastern Europe, through direct aid and technical assistance. And we continue to support the critical role of our international financial institutions, including the IMF and the World Bank.

Mr. Chairman, thank you for allowing me to present my statement.

[The following was supplied by Secretary Brady:]

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

MODERNIZING THE FINANCIAL SYSTEM:
RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS

FEBRUARY 5, 1991

FACT SHEET

The Need for Reform

It is time to modernize our financial system to make banks safer and more competitive:

- We must modernize our banking system, updating outmoded laws that date back to the 1930s.
- Banks must be sound to protect depositors and taxpayers.
- A strong, internationally competitive banking system is essential to a strong, growing economy.

The Banking System is Under Stress

- Technology has revolutionized the way financial institutions do business, but our banks are hampered by out-of-date rules.
- Weak banks shrink lending when the economy slows, hurting businesses and costing jobs.
- Our banks are falling behind international competitors: Only one of the 30 largest banks in the world is American, compared to nine of 30, including the top three, just 20 years ago.

NB-1112

The Benefits of Reform

A modern, safe and internationally competitive banking industry will protect depositors and taxpayers, serve consumers, benefit workers and businesses, and strengthen our nation.

Protect depositors and taxpayers:

Depositor confidence and taxpayer protection will result from:

-- A safe, competitive, well-capitalized banking system;

-- limitations on taxpayer exposure to losses from bank failures;

-- and a strong, well-capitalized insurance fund.

Serve consumers:

An efficient, integrated financial services system will mean:

-- Consumers will have access to a wider range of services at the least possible cost.

-- Consumers also will enjoy the convenience of nationwide access to services.

Benefit workers and businesses:

A healthy banking system with strong, competitive banks will ensure:

-- Jobs are preserved because loans are not called at the first sign of economic downturn.

-- Small businesses that lack access to securities markets can count on banks in bad times as well as good.

Strengthen the nation:

A world-class financial services system provides a foundation for a world-class economy:

-- International economic leadership in the 21st century will require an internationally competitive financial services system.

The Principles Governing Reform

First, we will preserve deposit insurance for small savers while protecting taxpayers by reducing the overextended deposit insurance system. Deposit insurance, originally intended to protect small depositors who could not protect themselves, has been expanded so that large, sophisticated investors receive unneeded protection. This reform will restore market discipline over risky activities that have increased the possibility of taxpayer exposure to losses in the banking system.

Second, we will make banks stronger and safer by strengthening the role of capital -- not by raising capital standards, but with a plan to attract capital to the banking industry. This will include rewarding well-capitalized banks with new activities that will attract still further capital, and taking prompt corrective action to address under-capitalized banks.

Third, we will make banks more competitive by modernizing outdated laws. Technological advances and other innovations in financial markets have put banks at a competitive disadvantage -- at home and abroad -- that has weakened the system and hurt the economy. Changes will allow banks to engage in a broader range of financial services and to operate nationwide.

Fourth, we will strengthen the banking system by making the regulatory structure more efficient. Currently, overlapping regulatory responsibilities lead to confusion and uneven results.

RECOMMENDATIONS

PART ONE: DEPOSIT INSURANCE AND BANKING REFORM

The Administration's deposit insurance recommendations go well beyond the narrow issue of deposit insurance and encompass the entire range of safety, soundness and competitiveness issues facing the banking system. They form a balanced, integrated package that must be considered as a whole. No single recommendation will be effective by itself, and indeed, could be counterproductive if adopted in isolation.

I. Strengthen the Role of Capital

The single most powerful tool to make banks safer is capital. Capital standards need not be raised, but the role of capital can be strengthened. This will discourage excessive risk-taking, reduce the possibility of bank failure, and provide a cushion to absorb losses ahead of the insurance fund and, ultimately, the taxpayer.

Well-capitalized banks are better able to keep lending, rather than shrinking loans to build capital ratios, during economic declines. And they are better able to meet competitive challenges and to take advantage of new opportunities.

Specific Recommendations:

Capital-based supervision, capital-based deposit insurance premiums and capital-based expanded activities (each described further in other sections of the report) will provide incentives for banks to build and maintain strong capital bases and make bank franchises more attractive. In addition, interest rate risk will be added to credit risk as a criterion for risk-based capital standards.

II. Reduce the Overextended Scope of Deposit Insurance

Deposit insurance, originally intended to protect small depositors who could not protect themselves, has been expanded so that large, sophisticated investors receive unneeded protection. This has increased the exposure of taxpayers to possible losses and decreased market discipline on risky banks.

By returning deposit insurance to its original purpose, we

can reduce the possibility that taxpayer funds will be needed to cover depositor losses, while simultaneously reintroducing market discipline that will help curb excessive risk.

Specific Recommendations:

Insured deposits:

"Pass-through" coverage of many types will be eliminated, reducing government protection for large, sophisticated institutional investors.

Brokered insured deposits will be eliminated, ending a practice that has given banks access to large pools of below-market-rate funds that are deposited without concern on the part of the depositor about the safety of the investment.

Individual insurance coverage will be limited to $100,000 per institution after a two-year phase-in period, plus another $100,000 per institution for a retirement account. This change will reduce taxpayer exposure to losses from coverage for wealthier individuals with multiple accounts, including individual, joint and revocable trusts, in a single failed institution.

The FDIC will be required to undertake an 18-month study of the costs and benefits of moving toward a systemwide $100,000 per person insurance limitation. This would more effectively limit taxpayer exposure to losses resulting from coverage of multiple accounts, but should not be implemented until it can be shown that the benefits would outweigh the potentially large administrative costs.

Uninsured deposits:

The government must preserve its ability to protect the banking system and the economy in genuine systemic risk circumstances. But protection of uninsured deposits as a matter of course both expands taxpayer exposure and encourages excessive risk-taking by banks. To limit coverage of uninsured depositors, the FDIC will be permitted to cover uninsured deposits only if that would be the least costly approach. To protect the system in rare instances of systemic risk, the Treasury and Federal Reserve could step in and order that uninsured deposits be covered. This policy would be implemented after three years to allow for an appropriate transition.

Non-deposit creditors:

While protecting uninsured deposits should be the rare exception, coverage of non-deposit creditors should be eliminated.

III. Risk-Based Deposit Insurance

Flat-rate premiums subsidize high-risk, poorly run institutions at the expense of well-run institutions and the taxpayer. There is a perverse incentive to take risks because there is no cost to offset the upside potential.

Specific Recommendations:

First, in the short-term, premiums based on capital levels will reward institutions that build capital to act as a buffer ahead of the insurance fund. In the longer term, a demonstration project may lead to premiums set by private insurance.

IV. Improved Supervision

Even with deposit insurance limits, the insurance fund and the taxpayer remain exposed to possible bank losses. Effective bank supervision can help. Capital standards need not be increased. But because well-capitalized institutions are the safest, regulation should be reoriented towards a system of capital-based supervision that provides rewards and penalties that encourage banks to hold adequate capital.

The rewards of capital-based supervision would be much greater regulatory freedom for well-capitalized banks to expand and engage in new financial activities. The sanctions of capital-based supervision would involve "prompt corrective action" to address problems as capital levels decline, well in advance of insolvency.

Specific Recommendations:

Capital-based supervision would establish five zones for banks based on their capital levels. Those with capital in excess of minimum requirements will be eligible to engage in a broad range of new financial services. Those with less than minimum capital would be subject to increasingly stringent corrective action -- including dividend cuts or even forced sale of the bank -- aimed at preventing failure.

V. Restrictions on Risky Activities

State-chartered banks with federal deposit insurance may be authorized by charter to engage in risky activities that are precluded for national banks. It is important to protect federal taxpayers from such excessive risks while maintaining state regulatory responsibilities under the dual banking system.

Specific Recommendations:

Federal deposit insurance qualifications would prohibit direct investment activities by state banks and limit activities not permitted for national banks.

VI. Nationwide Banking and Branching

Nationwide banking and branching would lead to safer, more efficient and more competitive banks, decreasing taxpayer exposure to losses. The U.S. is the only major industrialized country without a truly national banking system. After 1992, members of the European Community will permit international banking throughout the EC. Not only do we put our banks at an international competitive disadvantage, but we also forego significant safety, efficiency and consumer benefits.

Already, 33 states permit nationwide banking and another 13 permit regional banking. Only four prohibit all interstate banking. So the trend is clearly toward interstate banking. Yet there is almost no authority for interstate branching. Given the cost savings and efficiency arguments for interstate branching, the advantages to consumers and taxpayers of interstate branching are clear.

Specific Recommendations:

Full nationwide banking will be authorized for bank holding companies following a three-year delay. Interstate branching will be authorized for national banks in any state in which the bank's holding company could acquire a bank. Thus, after the three-year delay, full nationwide branching will be permitted.

VII. Modernized Financial Services Regulation

Banks are no longer the protected and steadily profitable businesses they once were. Technological advances and innovations by competing financial services providers have ended their monopoly on transaction accounts and certain types of business credit. They no longer enjoy protected access to low-cost funds from interest rate controls. And old laws that once protected them from competition have become barriers that impede banks from responding to changing market conditions. The result has been declining profitability and increasing bank failures. The losers are not just banks, but also depositors, taxpayers and the overall strength of the economy.

Out-of-date laws must be adapted to permit well-capitalized banks to reclaim the competitive opportunities they have lost to changing markets. Banks with expertise in other financial

services should be allowed to provide them for consumers, and other financial services companies with natural synergies with banking should be allowed to invest in banks. This will provide new sources of capital for the banking system and help promote safe, strong, well-capitalized banks.

The proposed changes will be accompanied by safeguards to prevent exposure of the federal deposit insurance fund to these new activities.

Specific Recommendations:

In order to strengthen the banking system, new rules will permit financial affiliates for well-capitalized banks. A new financial services holding company structure will permit a single company to own affiliates engaging in banking, securities, mutual funds and insurance. The new rules will allow commercial firms to own financial services holding companies.

To protect the deposit insurance fund and the taxpayer, only well-capitalized banks will be permitted to engage in new financial activities. Only the bank will have access to deposit insurance, strict regulation will be focused on the bank, and the new financial activities will be in separately capitalized affiliates.

VIII. Credit Union Reforms

The law required a study of adequacy of capital in the credit union industry and insurance fund and of the regulatory structure governing the credit union industry.

Specific Recommendations:

To ensure adequate capitalization of the credit union insurance fund, the double counting of fund assets will be eliminated over 12 years. To provide Administration accountability for credit union regulation, the federal banking regulator will serve on the National Credit Union Administration Board.

PART TWO -- REGULATORY RESTRUCTURING

The current regulatory structure is complicated, overlapping and confusing. Individual institutions often are supervised by several regulators, and bank holding companies rarely have the same regulator as their subsidiary banks.

A redesigned structure should reduce duplication and

improve consistency, accountability and efficiency. It should also separate the insurer from the regulator.

Specific Recommendations:

The present four-regulator model (the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and Office of Thrift Supervision) will be simplified to two, with the same regulator responsible for a bank holding company and its subsidiary bank.

The Federal Reserve will supervise all state-chartered banks and their holding companies. A new Federal Banking Agency under Treasury will supervise all national banks and their holding companies. When a holding company owns both state-chartered and national banks, jurisdiction over the entire organization will go to the charterer of the largest subsidiary bank. The Federal Banking Agency will take over OTS responsibilities on the date it completes assigning thrifts to the RTC.

The FDIC will be focussed on insurance and resolution of failed institutions.

PART THREE -- RECAPITALIZATION OF THE BANK INSURANCE FUND

The Bank Insurance Fund (BIF) has experienced losses in each of the last three years due to increasing numbers of bank failures. FDIC projects additional losses over the next two years that, under the most pessimistic assumptions, could exhaust the fund's net worth. The FDIC must exercise the authority given to it in the FDIC Assessment Rate Act of 1990 to recapitalize the BIF fund in the near term. Because the FDIC has the authority and because industry participation is essential, a plan to recapitalize the fund ought to be worked out with the industry by the FDIC within the following parameters:

Goals of Recapitalization

1. The plan should provide sufficient resources.

2. It should take into account any impact on the health of the banking system.

3. It should rely on industry funds.

4. It should use generally accepted accounting principles.

Senator EXON [presiding]. Dr. Boskin, do you have any opening remarks that you wish to make?

Mr. BOSKIN. Yes, I do, Senator.

Senator EXON. We will be glad to entertain your remarks now.

Mr. BOSKIN. I will ask that the full testimony be placed in the record.

Senator EXON. Without objection, so ordered.

STATEMENT OF DR. MICHAEL J. BOSKIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Dr. BOSKIN. Distinguished members of the committee, it is a pleasure to again appear before you today to discuss the administration's economic outlook and its relation to the budget. Secretary Brady has discussed selected key features of the budget and administration policy initiatives.

After almost 8 years of economic expansion, the longest peacetime expansion in the history of the United States, the economy entered a recession during the latter part of 1990. In the fourth quarter of the year, real gross national product registered its largest decline since 1982, and industrial production fell sharply. The downturn was caused in large part by the economic effects of Iraq's invasion of Kuwait. That caused a jump in oil prices and directly reduced business and consumer confidence. Those factors, coupled with continuing uncertainty about the timing of the resolution of the crisis, dealt a substantial blow to an economy already sluggish due to several factors. These included worldwide increases in interest rates, unexpectedly tight credit conditions, and the lingering effects of a tightening monetary policy from early 1988 through mid-1989, which was undertaken in a successful attempt to prevent an increase in inflation.

Several factors suggest that the economic downturn is not likely to last long and that a recovery will begin by the middle of 1991. Inflation, after adjusting for the temporary impact of the oil price increase, remained under control during 1990, and slowed at the end of the year. Because inflation remains much lower than in the 1970's and lower than rates that existed as we entered the last three recessions, the Federal Reserve has greater latitude to mitigate the current recession without causing an increase in inflationary expectations. The prospect for export growth continues to be strong. Inventories remain relatively low, suggesting that firms need not cut production as much as in previous recessions to reduce inventory levels. Interest rates declined toward the end of the year following passage of the new budget law, an easing of monetary policy, and the decline in the economy. Lower interest rates will stimulate credit-sensitive sectors of the economy and will increase growth after a lag of several quarters.

The administration forecasts that growth will be 0.9 percent over the four quarters of 1991. It is expected that the downturn will continue through the first part of 1991 and the recovery will begin in the middle of the year.

I want to emphasize something about the forecast that is contained in the budget and the economic rationale for it, which we describe in detail in the Economic Report of the President, to be

released next week. The forecast contains two consecutive negative quarters of real growth, the fourth quarter of 1990 and the first quarter of 1991, and was conveyed to the Congress by OMB in mid-January. This will be the ninth post-war recession, and it is only the second time an administration, Republican or Democrat, has forecast a recession prior to actually receiving data on two negative quarters of GNP—indeed, in this case, before receiving data on one.

We believe that growth should strengthen in 1992 and remain well above the very meager pace of the past 18 months through the mid-1990s. Inflation and interest rates are projected to decline gradually.

You are no doubt aware that in late January the Commerce Department published its preliminary estimate of the fourth quarter of 1990 GNP, a decline of 2.1 percent, which brought real GNP growth on a year-over-year basis for 1990 to just 0.9 percent. The decline in the fourth quarter was expected, and, indeed, it was somewhat smaller than many analysts, including the administration, had predicted. It may be that some of the decline we anticipated in the fourth quarter of 1990 will instead occur in the first quarter of 1991.

Let me just try to indicate some of the forces that led to the downturn last year that we expect to be mitigated or to ease in the future.

First, and most obvious, crude oil prices nearly doubled in the 2 months following Iraq's invasion of Kuwait. This put a large drag on consumer and business income and severely shook business and consumer confidence, both of which reduced spending. Both Secretary Brady and I have pointed out repeatedly that this so-called oil shock following Iraq's invasion of Kuwait would cause a significant hit to GNP, which was likely to be concentrated in the fourth quarter of 1990 and the first quarter of 1991.

Second, long-term interest rates rose worldwide in the early part of 1990, pushed up by anticipated increases in the demand for capital in Eastern Europe, especially the former East Germany, and by concerns about accelerating inflation. The rise occurred when long-term interest rates were already high, in part because of the large Federal deficits and the prospect that they might continue indefinitely.

Secretary Brady has already mentioned several of these things. But let me just say, to get one idea across about the changed international financial climate relative to 2 or 3 or 4 years ago, that the current account surpluses that existed in the former West Germany and Japan several years ago have been reduced substantially. Indeed, the starkest example is the unified Germany, which now has moved from a budget surplus to a budget deficit of 4 or 5 percent of GDP in order to finance unification of Germany. So the economic environment in which America attracts capital around the world has changed considerably relative to several years ago.

The more restrictive monetary policy from the spring of 1988 through mid-1989, as I said, undertaken to ward off possible increases in underlying inflation, slowed the economy in 1989 and 1990 as higher interest rates discouraged spending. Although this policy did reduce economic growth, it was successful in containing underlying inflationary pressures and left the Federal Reserve in a

better position to mitigate the downturn. I think it is useful to compare the current situation the Federal Reserve is in with that of the last two oil shocks. The first occurred in 1973–74, and preceded what at the time was the worst post-war recession in 1974–75. The second oil price shock, 1979–81, preceded what became the worst postwar recession, in 1981–82. In both of those previous episodes, inflation and interest rates were in double digits and rising even before the oil shocks. The Federal Reserve at the time had been following an inflationary monetary policy and was going to have to tighten—clamp down on money and credit growth to try to reduce that double-digit inflation. That situation was exacerbated by the two oil price shocks in the 1970's and put the Fed in an untenable position; and, indeed, the Fed did tighten and we wound up in the two worst postwar recessions.

Things are quite different now. Inflation, stripped of its energy component which collasped in 1986 and went up in 1990 while still well above zero, has been averaging 4 to 5 percent, for 7 years. So core inflation has been relatively stable, and one-half to one-third the level of the two previous shocks. Monetary growth has been at the lower end of the Fed's target range, and, indeed, the Fed has begun to take steps to mitigate the downturn, especially in the last couple of months.

Finally, tighter credit market conditions contributed to the slowdown in 1990 by reducing the availability of loans to some creditworthy borrowers. Undoubtedly, people will be doing studies trying to partition what caused what, and what percentage was due to different things. But banks and other financial institutions did tighten lending standards for several reasons. I won't try to assign percentages, but the reasons include: greater risk of default associated with a slowing economy; the falling value of collateral for residential and commercial real estate loans as real estate values fell; the need to increase the ratio of capital to loan assets to meet minimum capital requirements; and the particular nature of the risk-based capital measure in that formula; and, to some extent, overzealous bank examiners undoubtedly discouraged some banks from making new loans.

These factors should unwind—certainly some of them have already begun to—and recovery is expected to begin in the middle of 1991.

I have indicated some of these factors. The decline in oil prices down to $20 to $21 has removed the direct effect of the oil shock. There is less transfer of income from America, American businesses, and households, to foreign producers of energy. Consumer confidence has stabilized. It has not rebounded yet. But with the low inventories, with the Fed in a better position, the automatic stabilizers in the budget working to cushion the decline, the decline in interest rates and so on and the prospects for export growth—these factors lead the administration and most private forecasters to expect a relatively short and mild recession. Indeed, the administration forecast, which was done in December and reiterated and confirmed in January by the Treasury, OMB, and the CEA, turns out to be almost identical to the average—which is sometimes mistakenly called a consensus—of the 52 private blue-chip forecasters.

And it is somewhat less optimistic than the Congressional Budget Office forecast for the near term.

I should say that there are various uncertainties in the forecast. One concerns what Secretary Brady has alluded to about the gulf situation—namely the path of oil prices. The availability of credit is another area of concern. If interest rates come down and credit is not forthcoming at those rates, the economy will have difficulty growing. So I should emphasize what I have done every time I have appeared before this committee and every time I give a forecast: Forecasting is an inexact science. We are predicting human behavior in the future which may not exactly correspond to the way people responded to the same situations, like an oil shock, in the past. There are various events that cannot easily be foreseen; for example, an oil shock itself.

So, for that reason, there is a range of uncertainty, and the consequences of that uncertainty deserve some attention. We began, when the Bush administration came into office, to change the nature of the reporting of the sensitivity of the budget to changes in economic assumptions by including some alternative overall scenarios—not just specific scenarios such as how sensitive the budget is to a 1-percent different interest or inflation rate. And those are presented in the budget and are discussed in detail in the forthcoming Economic Report of the President. There is a higher growth forecast that assumes growth will rebound more quickly and more solidly in 1991 that would bring the unemployment rate down some, while the inflation rate would not fall as much as in our baseline. The lower growth forecast assumes that GNP will decline for the four quarters of 1991, which would cause unemployment to be higher, but inflation to come down a little bit more.

We should emphasize that in the long run we do expect the economy to make progress in getting back toward its underlying growth potential, which we believe is around 3 percent.

Let me just conclude, Mr. Chairman, by stating that while these facts and forecasts are important in and of themselves, the forecasting exercise highlights the importance of economic policies. Secretary Brady emphasized the importance of policies to enhance investment, entrepreneurial activities, saving, and productivity growth, and that obviously is the surest way to see continued rises in the standard of living of the American population. The Nation has taken an important step to raising national saving and investment with the Omnibus Budget Reconciliation Act of 1990, which has already been discussed and about which I won't go into further detail. The administration strongly supports tt and intends to abide by it and use it as our reference point. We also support a credible monetary policy program that mitigates the current recession and then sustains economic growth while controlling underlying inflationary pressures. We support policies that increase the role of market forces, decrease the role of regulation, and improve regulation in those areas where regulation is necessary.

We also support policies that encourage investment, entrepreneurship, work effort, research and development—Secretary Brady has gone into more detail on those—policies that improve the educational system's performance and policies that provide increased opportunities for the disadvantaged to enter the mainstream of the

American economy. We also support policies that continue America's historic role of leading the world to expanded trade, more open markets, and freer and fairer trade.

Let me finally make one last comment as requested in your invitation letter, Mr. Chairman. Let me just say a word about the financial sector. Strong economic growth requires a financial sector that is sound, efficient, and innovative. Banks in the United States still operate under a regulatory system that dates from the 1930's. The system attempts to keep banks healthy and the deposit insurance system sound by limiting competition. That system is simply no longer workable, since U.S. banks face increasing competition from other institutions both here and abroad.

The long-term vitality of the U.S. banks depend on their ability to compete effectively. If the proposals described in the Treasury study announced yesterday by Secretary Brady are adopted, U.S. financial institutions would be healthier, better able to attract capital, and more competitive internationally.

Thank you very much, Mr. Chairman.

Chairman SASSER [presiding]. Thank you, Dr. Boskin.

[The prepared statement of Dr. Boskin follows:]

TESTIMONY OF MICHAEL J. BOSKIN

CHAIRMAN, PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS

BEFORE THE SENATE BUDGET COMMITTEE

February 6, 1991

Chairman Sasser, Senator Domenici, and other distinguished members of the Committee, it is a pleasure to appear before you today to discuss the Administration's economic outlook and programs, and their relation to the budget. I will also discuss, at your request, certain problems in the financial sector and their impact on the economy. Secretary Brady has discussed selected key features of the budget and Administration policy initiatives.

After almost eight years of expansion, the economy entered a recession during the latter part of 1990. In the fourth quarter of the year, real gross national product (GNP) registered its largest decline since 1982, and industrial production fell sharply. The downturn was caused in large part by the economic effects of Iraq's invasion of Kuwait. That caused a jump in oil prices and directly reduced business and consumer confidence. Those factors, coupled with continuing uncertainty about the timing of the resolution of the crisis, dealt a substantial blow to an economy already sluggish due to several factors. These included worldwide increases in interest rates, unexpectedly tight credit conditions, and the lingering effects of a tightening of monetary policy from early 1988 through mid-1989 which was undertaken in a successful attempt to prevent an increase in inflation.

Several factors suggest that the economic downturn is not likely to last long and that a recovery will begin by the middle of 1991. Because inflation, after adjusting for the temporary impact of the oil price increase, remained under control during 1990 and slowed at the end of the year, the Federal Reserve has greater latitude to mitigate the recession without causing an increase in inflationary expectations. The prospect for export growth continues to be strong. Inventories remain relatively low, suggesting that firms need not cut production as much as in previous recessions to reduce inventory levels. Interest rates declined toward the end of the year following passage of the new budget law, an easing of monetary policy, and the decline in economic activity. Lower interest rates will stimulate credit-sensitive sectors of the economy and will increase growth after a lag of several quarters.

The Administration forecasts that growth will be 0.9 percent over the four quarters of 1991. It is expected that the downturn will continue through the first part of 1991 and the recovery will begin around the middle of the year. If the Administration's proposed policies are enacted, the long-term economic outlook is good. Growth should strengthen in 1992 and remain well above the rates of the past 18 months through the mid-1990s. Inflation and interest rates are projected to decline gradually.

The projections reflect our view that the United States economy is fundamentally healthy. It also reflects our view that the Administration's approach to policy--emphasizing the power of private markets to generate growth and jobs, pursuing deregulation where desirable and more sensible regulation when regulation is necessary, increasing national saving, and developing and adhering to policies that take the long view--best promotes sustained economic growth. The conditional nature of our forecast must be emphasized: it assumes implementation of the Administration's economic policy proposals, as well as adherence to deficit reduction as mandated in the Omnibus Budget Reconciliation Act of 1990. Economic policy should enhance the economy's potential for growth and ensure that it operates more frequently at its potential than in previous decades. In designing policies to meet this goal, it is important to be ambitious but realistic. Setting the Nation's sights too low guarantees mediocre performance. Setting hopelessly unrealistic goals guarantees disappointment.

Economic Developments in 1990

You are no doubt aware that on January 25th the Department of Commerce reported that real GNP declined by 2.1 percent at an annual rate in the fourth quarter of 1990. This decrease was the sharpest decline since 1982 and brought real GNP growth on a year-over-year basis to 0.9 percent (0.3 percent on a fourth-over-fourth basis). The decline in the fourth quarter was expected, although it was somewhat smaller than many analysts, including the Administration, had predicted. It may be that some of the decline we anticipated in the fourth quarter of 1990 will instead occur in the first quarter of 1991.

There were several forces that led to the downturn at the end of last year, and we expect that these forces will fade in importance in the future.

- First, and most obvious, crude oil prices nearly doubled in the two months following Iraq's invasion of Kuwait. This put a large drag on consumer and business income and severely shook consumer and business confidence, both of which reduced spending. Both Secretary Brady and I have pointed out repeatedly that the "oil shock" following Iraq's invasion of Kuwait would cause a significant hit to GNP, which was likely to be concentrated in the fourth quarter of 1990 and the first quarter of 1991.

- Second, long-term interest rates rose worldwide in the early part of 1990, pushed up by anticipated increases in the demand for capital in Eastern Europe, especially the former East Germany, and by concerns about accelerating inflation. The rise occurred when long-term interest rates were already high, in part because of large Federal deficits and the prospect that they might continue indefinitely. High interest rates also slowed the growth of consumer and business spending.

- Third, there was a more restrictive monetary policy from the Spring of 1988 through mid-1989, undertaken to ward off an anticipated increase in the underlying inflation rate. The lagged effects of this policy also slowed the economy in 1989 and 1990, as higher interest rates discouraged spending. We should note, however, that although it reduced economic growth, this monetary policy was successful in containing inflationary pressures and left the Federal Reserve in a better position to mitigate the downturn.

- Finally, tighter credit market conditions contributed to the slowdown in 1990 by reducing the availability of loans to some creditworthy borrowers. Banks and other financial institutions tightened lending standards for several reasons, including greater risks of default associated with the slowing economy, the falling value of collateral for residential and commercial real estate loans as real estate values fell, and the need to increase the ratio of capital to loan assets to meet minimum capital requirements. In addition, overly zealous bank examiners discouraged some banks from making new loans.

For reasons I will point out in a moment, as these factors unwind, a recovery is expected to begin toward the middle of 1991.

Forecast for 1991 and 1992

For 1991 as a whole, we expect GNP to expand 0.9 percent on a fourth-quarter-to-fourth-quarter basis, up from the 0.3 percent growth of 1990. The quarterly pattern of the forecast contains two quarters of declining real GNP: the fourth quarter of 1990 and the first quarter of 1991, so that most of the 1991 growth occurs in the second half of the year. Consistent with the sluggish production performance expected in 1991, we expect the unemployment rate to average 6.7 percent in 1991.

The decline in oil prices in November and December and the falling capacity utilization and rising unemployment rates that are accompanying the present downturn are expected to contribute to a decline in inflation in 1991. The Administration forecasts that CPI inflation will be 4.3 percent during 1991, compared with the 6.5 percent rate of 1990.

The slack economy, falling inflation, and, perhaps most important, the demonstrated willingness on the part of the Federal Reserve to mitigate the current downturn by reducing the Federal funds rate and the discount rate are projected to allow interest rates to average about a full percentage point below their 1990 levels in 1991.

The Recession: How Long? How Severe?

The projected recession is likely to be mild. Compared with the 2.6 percent average real GNP decline associated with the 8 other postwar recessions, the Administration projection contains a 1.2 percent decline. A recovery beginning in the second quarter of 1991 would make this recession slightly shorter than the 11 month average postwar recession. There are several reasons why this recession is likely to be relatively short.

- Crude oil prices have fallen substantially from their October peak, especially after the successful start of Operation Desert Storm. The decline has already begun to remove a large drag on consumer and business income. Consumer confidence has stabilized, although it has not yet shown signs of rebounding.

- As I noted earlier, inventories are low relative to sales, suggesting that the sharp inventory liquidation that has accompanied and worsened most previous recessions is unlikely to occur.

- Because underlying, or core, inflation was much lower and relatively stable going into the recession than at the onset of the three previous recessions (1974-75, 1980 and 1981-82), the Federal Reserve has had the latitude to begin to take steps, from discount rate and federal funds rate decreases to lowering reserve requirements, to mitigate the downturn without causing an increase in inflationary expectations, in part because they have gained credibility by keeping inflation relatively contained during eight years of expansion. In the early stages of other recessions, such as the 1981-82 recession, the Federal Reserve pursued a tight monetary policy to fight high and rising inflation and inflationary expectations.

- The automatic stabilizers in the budget--both the natural decrease in tax receipts and the increase in benefit payments accompanying an economic downturn--quickly and automatically cushion the decline in household and business income and spending.

- Interest rates have come down substantially since the beginning of the fourth quarter of 1990 and are likely to decline further. Although it can take several quarters for the full effect of declining interest rates to benefit the economy, by mid-year, interest-sensitive sectors such as big ticket consumer durable purchases should improve.

- The prospects for export growth remain good; exports have been at record levels and are one of the bright spots in the economy, cushioning the effects of the recession.

While these factors lead the Administration and most private forecasters to expect a relatively short and mild recession, there are downside risks as well. For example, there is still uncertainty regarding the future path of oil prices. The availability of credit is another area of uncertainty. And, even though interest rates are coming down, if credit is not forthcoming at these rates, the economy will be stymied.

Uncertainty in the Forecast

Forecasting is an inexact science. Natural disasters and other unexpected developments can cause forecasts to go awry. Changes in the policies upon which the forecasts are based can cause actual events to be substantially different from the forecast. Ultimately, economic forecasts are based largely on predictions about human behavior, usually taking the previous patterns of behavior as a guide. But human behavior is complex, difficult to predict, and subject to change. People do not always respond the same way, or with the same speed, in what appear to be similar circumstances.

The range of uncertainty and its consequences deserve nearly as much attention as the forecasts themselves. For that reason, the Administration has developed alternative forecast paths that are consistent with higher growth and lower growth than those previously mentioned. The higher growth forecast assumes 1.3 percent growth for 1991, equal to the CBO 1991 forecast. This would bring the unemployment rate down to 6.5 percent for the year, and the inflation rate would not fall as much as in the budget assumptions. The lower path assumes a 1.3 percent decline in real GNP for the four quarters of 1991, resulting in a 7.1 percent unemployment rate and a slight reduction in inflation relative to the baseline. These paths would have a small, but noticeable effect on the budget deficit in fiscal 1991 and a somewhat larger effect in fiscal 1992. There is even a small probability that the economy could perform outside these ranges, either for the better or the worse.

Longer-Run Economic Projections

Let me conclude my discussion of the forecast by sketching out the Administration's longer-run economic projections, that for the years 1993 and beyond. These projections reflect our view of fundamental demographic trends in the economy and the impact that sound economic policies will have on productivity. Our forecasts incorporate the standard assumption of an average increase in the civilian labor force of 1.3 percent a year, slower than the pace of the 1980s as the incorporation of the postwar baby boom generation into the labor force is completed.

We expect that productivity growth will offset the slowdown in labor force growth, reflecting a more skilled and experienced labor force. In addition, policies promoting higher national saving, lower real interest rates, and a lower cost of capital, will promote increased investment in plant and equipment and research and development. Together, these are expected to help achieve productivity growth of 1.9 percent a year. While this figure exceeds the average increase over the past two decades (which include the abysmal productivity performance of the 1970s) it is about equal to long-run economic productivity growth since World War II. We think that long-term productivity growth in the early 1990s of 1.9 percent per year is a realistic, achievable goal. It is important to note that the productivity figures for 1990 were not very good and, in fact, showed productivity declining. We believe that this is a temporary phenomenon associated with a cyclical slowdown. Low or falling productivity is typical in a slowdown or recession, since many firms tend to retain workers rather than face costly hiring and retraining when more normal demand conditions appear. Thus, output falls more than employment, and productivity, or output per worker or worker hour, declines temporarily.

Economic Policies

The facts, figures, and forecasts that I have discussed are important in and of themselves. We all recognize, for example, the importance of low unemployment and inflation rates and strong growth in the gross national product. The forecasting exercise also spotlights economic policies. It gives us the opportunity to reflect on the potential dangers of misguided economic policies. And it makes clear what sound government policies can do to promote a healthy economy.

Let me now briefly outline the Administration's economic policy goals and address some of the specific questions you have raised about certain aspects of policy.

The Administration's fiscal, monetary, trade and regulatory policy goals are designed to achieve the maximum sustainable rate of economic growth, by both enhancing the Nation's potential output and ensuring the economy generally operates at its potential. The goals are as follows:

1) Raise national saving to stimulate investment and future economic growth by reducing the Federal structural budget deficit through adherence to the Omnibus Budget Reconciliation Act of 1990;

2) Support a credible monetary policy program that mitigates the current recession and then sustains economic growth while controlling underlying inflationary pressures;

3) Support policies that increase the role of market forces and decrease the role of regulation, and improve regulation in those areas where regulation is necessary;

4) Support policies that encourage investment, entrepreneurship, work effort, and research and development, that improve the educational system, and that provide increased opportunities for the disadvantaged; and

5) Lead the world to expanded trade and more open markets.

The Nation has already taken an important step to raising national saving and investment by enacting the Omnibus Budget Reconciliation Act of 1990, which contains the largest and most comprehensive deficit reduction package in U.S. history. It is designed to reduce the Federal deficit by a total of nearly a half-trillion dollars over the next five years, relative to what it would otherwise be. The law contains credible enforcement mechanisms, using caps on discretionary spending and pay-as-you-go rules on mandatory spending, and several types of sequesters to prevent new legislation from increasing the budget deficit.

The Administration remains committed to a tax system with low marginal tax rates and the lowest possible barriers to saving, entrepreneurship, and productive investment. The Administration has proposed a reduction in the tax rate on long-term capital gains. A capital gains tax cut would affect real estate and other asset values favorably, thereby alleviating capital and balance sheet problems in both financial and nonfinancial corporations. It would also reduce the existing bias against financing through equity rather than through debt.

To further stimulate private saving and investment, the Administration has proposed to make the research and experimentation (R & E) tax credit permanent, to establish Family Savings Accounts, and to ease requirements for withdrawals from Individual Retirement Accounts for people purchasing a home for the first time. In my professional judgement, all of these proposals will raise national saving and capital formation. Lower capital gains tax rates will also encourage entrepreneurial activity, a sparkplug of economic growth.

Financial Sector Problems

As requested by the Committee, I would now like to turn my attention to the financial sector. Strong economic growth requires a financial sector that is sound, efficient, and innovative. Banks in the United States still operate under a regulatory system that dates from the 1930s. This system attempts to keep banks healthy and the deposit insurance system sound by limiting competition. That system is simply no longer workable, since U.S. banks face increasing competition from other institutions both here and abroad. The long-term vitality of U.S. banks depends on their ability to compete effectively. If the proposals described in the Treasury study announced yesterday by Secretary Brady are adopted, U.S. financial institutions would be healthier, better able to attract capital, more competitive internationally, and the deposit insurance system would be improved.

In the current situation, as I mentioned earlier, tight credit conditions are partially responsible for pushing a sluggishly growing economy into recession. Tight conditions were the result of a variety of factors. A slowing economy increased the risks of lending. The value of collateral on residential and commercial real estate loans fell with declining real estate values. The need to increase the ratio of capital to assets to meet recently established international minimum capital requirements forced some banks to curtail loan growth. Overly zealous bank examiners discouraged some banks from making new loans. The Administration believes more sound banks should be making sound loans to creditworthy customers and, under the leadership of the Treasury Department, has been working with the bank regulators to ensure that prudent oversight compatible with such lending practices is implemented.

Mr. Chairman, I would now be happy to answer any further questions you or the members of your Committee may have.

TABLE 1
Comparisons of Economic Projections

	Fourth-Quarter-to-Fourth-Quarter Percentage Change	
	1991	1992
Real GNP		
Administration	0.9	3.6
CBO (1/91)	1.3	3.4
Blue Chip Average (1/91)	0.9	2.8
GNP Deflator		
Administration	4.3	3.8
CBO (1/91)	4.1	3.6
Blue Chip Average (1/91)	4.0	3.6
CPI		
Administration	4.3	3.9
CBO (1/91)	4.0	3.5
Blue Chip Average (1/91)	4.1	4.0
	Levels (Annual Averages)	
Unemployment Rate (Total)[1]		
Administration	6.7	6.6
CBO (1/91)	6.7	6.3
Blue Chip Average (1/91)	6.4	6.2
3-Month Treasury Bill Rate		
Administration	6.4	6.0
CBO (1/91)	6.6	7.0
Blue Chip Average (1/91)	6.3	6.5
10-year Treasury Rate		
Administration	7.5	7.2
CBO (1/91)	7.9	7.7
Blue Chip Average[2] (1/91)	7.8	8.0

[1] CBO and Blue Chip forecasts are forecasts of the civilian unemployment rate converted to total unemployment rate by subtracting 0.1 percentage point (the historical average difference).

[2] Blue Chip does not project a 10-year interest rate. The values are based on the Blue Chip projection of the Aaa bond rate adjusted for the estimated spread between those bonds and the government rate.

TABLE 2
Administration Longer Run Projections

	1990	1991	1992	1993	1994	1995	1996
	Fourth Quarter to Fourth Quarter Percent Changes						
Real GNP	0.3[1]	0.9	3.6	3.4	3.2	3.0	3.0
GNP Deflator	4.0[1]	4.3	3.8	3.6	3.5	3.4	3.3
CPI	6.3[1]	4.3	3.9	3.6	3.5	3.4	3.3
	Levels (Annual Averages)						
Civilian Unemployment Rate	5.5[1]	6.8	6.7	6.3	5.9	5.5	5.2
10-Year T-Note	8.6[1]	7.5	7.2	6.8	6.6	6.4	6.3
3-Month T-Bill	7.5[1]	6.4	6.0	5.8	5.6	5.4	5.3

[1] 1990 is preliminary, based on the Advance Commerce Department estimate for 1990:IV.

Chairman SASSER. Secretary Brady, I want to commend you on one facet of the plan that you have presented related to the banking industry, and that is what I perceive to be a risk-based premium for deposit insurance. I think that is a very healthy step forward. In my view, those institutions that take a larger risk with the Deposit Insurance Corporation's money ought to have to pay a larger premium for that insurance.

Having said that, though, there are some questions that the proposal raises in my mind, and I know you have given this a lot of thought, both you and your colleagues. But there are some aspects of the plan that give me somewhat of an uneasy feeling. In the immortal words of Yogi Berra, it is sort of like deja vu all over again.

What do we say to those who say, "Look, this is just the way it was in the early eighties, when the S&L's were coming in and saying we've got to expand our powers, we've got to be more like commercial banks, we've got to be able to diversify, to get into more business, and if we don't, we are not going to be able to survive." The S&L's were weak at that time and we allowed them to go ahead and do that, and we all know the disaster that occurred that we are still paying for now.

Now, the Treasury Department comes to us now and others are saying the problem with the banks—and Dr. Boskin just said—the problem with the banks, they have got to be able to compete, they have got to be free to compete, they have got to be able to get into new lines of business, into insurance, they have got to be able to sell equities, stocks, et cetera.

Now, we are sitting here with a weakened banking structure. What is the difference between where we are now with the banks and where we were in the early eighties with the S&L's and we were wanting to broaden their powers?

Secretary BRADY. Chairman Sasser, I think this is the question that is on everybody's mind, but I really wonder if the similarities between the banking industry and the S&L industry are not overstated. To give you my view, I think they are overstated.

First of all, the capital in the banking industry is roughly $200 billion. It was $10 billion in the S&L industry when the problem arose there, so that is a vast difference. I would say that the regulatory authorities—the Fed, the OCC and the FDIC that regulate the banking industry—are much stronger, more experienced authorities, than was evident in the S&L industry. We know what some of the problems are there.

Frankly, the investments that banks have made are not in any regard similar to the ones that the S&L's have made. You remember from the S&L days that there were all manner of investments—windmill farms we have heard about, condos, golf courses, raw land, you name it. Banks are not permitted to make these kind of investments.

Now, it is true that a decline in values in the real estate industry give the impression that this is the same driving cause, but I would say that the similarity ends there.

Lastly, we are not talking about allowing these alternate forms of business taking place inside the banks. The banks will still have solid walls around them, and any activities that have been suggest-

ed in this legislation will be done in a subsidiary that does not have access to the Federal Deposit Insurance safety net.

So, I really do feel that, although the question is a good one and is one that will be argued on a continuing basis as we go forward with this legislation, I just do not believe that the similarity is as strong as the question would indicate.

Chairman SASSER. Well, I think it is something we are going to have to look at very carefully. I must say that I still have flashbacks of the early eighties, when the S&L people were coming up and telling us, "Just let us get out into greener pastures and everything is going to be all right." Of course, it was not that way.

Let me ask you this question, Mr. Secretary. OMB is predicting, as you know, the insolvency of the Federal Deposit Insurance Corporation. Is the banking industry going to be able to pay for the FDIC's insolvency, in your judgment?

Secretary BRADY. Well, Chairman Sasser, like you, I feel it is enormously important that we have a strong bank insurance fund that the American people can look at and say, yes, that is plenty strong enough to get this job done. And there have been any number of different estimates by OMB, CBO and the FDIC itself on what the future of the BIF is really going to look like.

At this moment in time, as you know, the BIF is actually literally inside the FDIC, and in our budget agreement this last year the responsibility for being able to raise bank insurance premiums to a level which would build back that surplus rests with the FDIC. They are meeting and the Treasury has been involved, but they are meeting as we sit to come forward with a plan that will reconstitute the bank insurance fund, and I think it would be a little premature of me to say what that is before Chairman Seidman gives his final plan.

Chairman SASSER. I might ask you this question. Are you fairly sanguine that the banking industry is going to be able to pay for the insurance fund's problems?

Secretary BRADY. My feeling is that what Chairman Seidman has said as of this last weekend, that it will be bank industry funds, is what I know about it at this particular point in time, and certainly that is our goal.

Chairman SASSER. One final question, following on the one that I just asked you. As you know, the large money center banks do not pay a deposit insurance premium on the foreign deposits that they hold, and in some of these banks foreign deposits make up over 50 percent of their total deposits.

Now, these large money center banks fall into the so-called too-bit-to-fail category, which meant that in times past, when banks like Continental of Chicago got into trouble, why, the insurance fund came in and paid everybody off or made all of the depositors whole, including the foreign depositors in excess of their $100,000 deposits, even though the foreign depositors paid no deposit insurance.

Now, if we are trying to get more funds into the deposit insurance fund, how can we justify these banks not paying premiums on the foreign deposits that they have, even though these foreign deposits are, in fact, insured?

Secretary BRADY. Well, for two reasons, Chairman Sasser. First of all, I was just looking for the figures in my book here, and I should be able to run right to them, but I cannot. I think I am accurate in saying, over the past years, that the larger banks who have these foreign deposits that you refer to have paid into that fund 70 percent of its revenues. In other words, 70 percent of the revenues and the sustenance in that fund have come from the larger banks. Yet, the resolution of those larger banks—and by larger banks, I am taking ones with over a billion dollars of assets—the amount of money that they have taken out of that fund is 50 percent. So, in terms of equity over time, the larger banks have paid more in than they have taken out, in terms of resolution costs.

Second, with regard to the foreign deposits, that is an enormously competitive business, with spreads and margins, that are in 16ths and 32nds, and any imposition on the part of the FDIC of an additional premium on those deposits would make the difference between them residing in U.S. banks and have them shooting to foreign banks. So those are the two reasons why we left it out.

Chairman SASSER. My time is expired.

Senator Domenici?

Senator DOMENICI. Mr. Chairman, since Senator Bond waited so long yesterday, I wonder if I might yield to him my time, and I will be second.

Chairman SASSER. Surely. Senator Bond?

Senator BOND. Thank you, Senator Domenici. I appreciate that very much, although it is not necessary.

I share, Michael, your reasonably optimistic view of the economy and where it is going. Frankly, as I talk to businessmen and women as well as bankers in my State, that they do not see the economy as weak as some of our commentators and economists, unfortunately, who are based in New England and New York, and they do not share in the general pessimism.

You mentioned the psychology of the recession. You are an advisor to the occupier of the bully pulpit. What can you do psychologically to help change that part of the economic downturn equation?

Dr. BOSKIN. Well, Senator Bond, the President has tried to square with the American people throughout concerning exactly what was going on. In the aftermath of the Iraqi invasion of Kuwait, he indicated he was concerned about a downturn. He first called it a recession before any of his advisers did.

In his speeches, the President has been trying to explain some of the strengths in the economy, as well as the weaknesses. Even when our economy does very well, there are areas and sectors that do not do as well, and when it is doing poorly, as it is currently, there are regions and sectors that are doing well. Exports remain strong, for example. Industrial exports and farm income generally have been pretty decent. The oil patch was recovering prior to the Iraqi invasion. The Pacific Northwest and Mountain States have been doing pretty well.

So, there is a large variation by sector and by region, and in some sense this is the mirror image, not quite, but something of a mirror image of what happened in the 1982 recession and the mid-

eighties, when the Midwest and the oil patch suffered very substantially, and the coasts were so-called recession proof.

There is some strength in the industrial Midwest, in terms of exports. The automobile industry, however, is in very bad shape and autos and real estate are the two worst parts of our economy. The President has been trying to indicate this and trying to compare the current situation and the current oil shock to previous ones. He wants to emphasize that we start from a strong foundation, and that despite the recession, the American economy is the largest economy, with the highest standard of living of any advanced economy, and the highest absolute level of productivity, and so on.

He has also tried to indicate some of the concerns. He is trying to make sure people are aware of what the facts are, aware of what the administration is trying to do. And hopefully that message will get out as a counter-balance to the perhaps more negative tone of some of the commentators.

Senator BOND. One of the things that I think is a concern to all of us in getting economic growth going again is the availability of credit. In addition, there has been obvious changes in international funds availability and where capital is going.

One of the problems that we have heard about from many areas of the country, is that they are suffering from a pendulum swing back from unduly lax days in regulation of lending by thrifts and by banks, to a point now where regulators are seemingly capriciously classifying loans which are performing loans, and that has a restrictive effect on the availability of credit.

I would like both the Secretary and Dr. Boskin to give us their views on that and what could be done about it, to make sure that we do have the credit we need to get out of the economic slowdown or recession.

Secretary BRADY. Senator Bond, let me tell you what we are doing. I have asked Deputy Secretary Robson, on an ongoing basis, to meet with everybody who has a precise knowledge of the problem that you are talking about; namely, our regulators exerting an effect on our banking industry which is greater than we need at this particular time.

This effort has been going on for some 2 or 3 months now. There will be specific regulations. He has met with the FDIC, the Fed, the OCC and the OTS, and I expect that within 10 days or so, we will have some recommendations to be made. They will be generally along the lines of what is known as bifurcated loans, where you can split a loan in half, so you do not have to classify both parts of it.

Also, an equally important point, is the fact that we are not sure that classifying bank loans which are, by their definition, unmarketable, to classifying them on a liquidation basis is really what ought to be done. Those loans were made for a period of time. There is no reason why a bank examiner and a bank officer cannot take a look at how that loan might look 2 or 3 years from now and classify it on that basis. It makes eminent good sense to us, but those are just 2 of 4 or 5 or 6 other things that are underway.

I was interested that Salomon Brothers, a Wall Street firm, has come out with a little document on how they see the thing going.

As usual, the information gets out sometimes faster than we think. So it is underway.

Senator BOND. Thank you, gentlemen.

Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Bond.

Senator Riegle?

Senator RIEGLE. I think we may have to subscribe to that Salomon Brothers newsletter up in the Banking Committee, so we can get these hot news items. [Laughter.]

Secretary BRADY. I just got it this morning.

Senator RIEGLE. Well, maybe you need to subscribe, too. I guess you do subscribe to it, so——

Secretary BRADY. We get it somehow, Senator.

Senator RIEGLE. First of all, I want to repeat something I said yesterday, and that is I want to commend you for your efforts in putting together this set of proposals with respect to strengthening the banking system and taking a serious look at how the regulatory and supervisory structure might be reengineered to make it stronger.

As you know, we are going to work with you in the Banking Committee to explore those proposals, once we have them in writing—which I guess we will in, what, a couple of weeks—so we will be proceeding with those and look forward to working with you.

One of the things, of course, that has been touched on this morning that was not addressed in that package yesterday, insofar as I was able to find it, was the question of how we replenish the deposit insurance system. As you know, GAO has come in now and said that their projection and prediction is that we will probably run out of money in the bank insurance fund before the calendar year is out—in other words, in the first quarter of the coming fiscal year—but by the end of this calendar year.

I think your proposal yesterday was generally silent on the question of how we recapitalize the fund, and I am wondering if you can give us any thoughts on that now, so that we can think about it in a budgetary sense.

Secretary BRADY. Senator Riegle, I answered the identical question for Senator Sasser just a minute ago. I would be glad to go through it.

Senator RIEGLE. I was down in the Finance Committee working on the trade agreements.

Secretary BRADY. I understand. I would be glad to repeat it, if you want, whichever way——

Senator RIEGLE. Well, can you just give me two or three sentences on it?

Secretary BRADY. Surely. Briefly, we feel as strongly as you do that a sound and big enough bank insurance fund is critically important for this country, big enough and strong enough so the American people can look at it and say, yes, that has got the job done.

As you know, the bank insurance fund is housed in an independent agency, the FDIC, and the budget agreement which was arrived at last fall gave them the authority, took the cap off deposit insurance funds, so that they can make recommendations as to what they ought to be. They have been working with bankers on a con-

temporaneous basis. We have been in those meetings, but I think, since it is an independent agency, Chairman Seidman ought to come forward first with his suggestion and then we will give you our view.

Senator RIEGLE. I appreciate that. The question that matters is, are you going to need public money?

Secretary BRADY. Well, I answered that question before, too, as well. At this point in time, I take my lead from Chairman Seidman, who said last weekend, at least I read in the press that he said, that he thought the matter could be handled from industry funds. Again, I would like to wait and see what he has to say.

Senator RIEGLE. So, we are not sure? I take it that means the issue is up in the air.

Secretary BRADY. Well, I think it depends on a lot of things. He has the authority to produce the amount of insurance premiums that, you know, can go all the way from—I believe they are 19.5 now, to 40 or 50 basis points. It is a question of what effect this would have on the banking industry, and I think we need to get his judgment on that first.

Senator RIEGLE. I take that answer to mean then that you are still looking at that and you don't know one way or the other.

Secretary BRADY. That is correct.

Senator RIEGLE. Now, let me ask you just with respect to the economy, and I am glad to hear things are a little more buoyant out in Missouri. I wish they were throughout the country. When you came in with the RTC Board the other day, Bob Larson, the independent member, said that he felt that we were still in a real estate value freefall across the country and expressed some real concern about it.

I am wondering—and I am asking both you and Mr. Boskin this—are you doing any contingency planning if this economic downturn continues to accelerate and worsen? Do you have some planning going on as to what you would do to break a fall if you find that it is moving faster and deeper than you now anticipate?

Secretary BRADY. Well, let me just take a short crack at that question, and Mike can answer as well.

Obviously, we are working hard, as I mentioned a moment ago to Senator Bond, to make sure that the banking industry acts as the shock absorber for the country in a downturn as closely as it should, because that is its function, and we are working with them to make sure that some of the regulations and laws surrounding their activities are ones that make sense in this context.

With regard to specific programs, our forecast—if this doesn't answer your question—indicates that this will be of a duration that comes back out of it at the end of the year. So that is what we feel.

Mike, you may want to answer more than that.

Dr. BOSKIN. I would just say that in the normal course of our jobs, we are always doing this sort of thing. When the economy is going well, we are doing this sort of thing. So certainly there is nothing that would be a surprise or novel or new or worthy of any headline or anything. The President's economic advisers, the Secretary of the Treasury, the CEA Chairman, the OMB Director, and others are always discussing these sorts of things.

Senator RIEGLE. Well, tell me what you are discussing. I know you are worried about the headline. I am interested in what you are looking at in the way of contingency plans in the event this thing is more serious than you now think it is.

Dr. BOSKIN. There is nothing that I would call a contingency plan per se. We have been trying to evaluate the relevant probabilities, and monitoring the economy and the banking sector. As Secretary Brady said, we are discussing and putting certain things into place. The Treasury Department is taking the lead and trying to work with the bank examiners to get some more sensible bank oversight.

Senator RIEGLE. It sounds to me, Mr. Chairman, like some form of forbearance. That is a word nobody likes to use, but change in bank practices is a central part of your strategy to try to break the fall of the economy.

Dr. BOSKIN. No, I wouldn't call it that at all. I think we just want the pendulum to be exactly in the middle. We want prudent oversight. I think there has been an enormous amount of evidence that there are some areas and regions where the pendulum had been too lax for a while, and perhaps, even inadvertently, it swung too far to the other side. So we are just trying to make sure that sound, prudent practices are followed and that people aren't inadvertently choking off credit to creditworthy borrowers.

Chairman SASSER. Senator Symms. Thank you, Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Senator SYMMS. Thank you, Mr. Chairman. Gentlemen, welcome to the committee this morning.

Mr. Secretary, Senator Riegle has expressed concern over the so-called, as he calls it, real estate freefall, but I would ask both of you: Wouldn't reducing the rate of taxation on the capital gains lessen that fall?

Secretary BRADY. Senator Symms, the capital gains discussion is one that we have been having for a long time, and I would just give you my view that I think capital gains does engender growth and put jobs and investment on the books. I would also say that I welcome Chairman Greenspan's role in trying to sort out how this matter is booked and scored by the various agencies in Government that we ask to do that.

Dr. BOSKIN. Senator Symms, as an analytical matter, property values tend to reflect the expected future rents and taxes—property taxes—and so on.

Senator Symms. It would put a floor on it.

Dr. BOSKIN. So certainly if capital gains taxes were reduced, there would be some increase in some asset values, including real estate values. How large that would be is difficult to determine.

Senator SYMMS. In view of the political situation that we are in, where the Democrats control the Congress, you have five tax proposals here that the administration favors. All of them look like good ones: family savings account, R&D research credits, enterprise zones, first-time home buyer withdrawal from IRA's, and a capital gains rate differential. But consider the politics, where the Democrats control the House and they control the Senate and they love tax increases—every year they have a tax increase. Last year you fellows gave them a little cover with the President, but now this year they want to raise taxes for the war. Would you rather just

leave the tax code alone, have no new taxes and none of your programs? Or are you prepared to face the attack that you will get by wanting these tax changes—they will want to raise rates and all these other things in exchange for what we want to do for the good of the economy? [Laughter.]

Secretary BRADY. Well, Senator Symms, I think there is a general proposition that we ought to leave the tax code more or less as it is. We have changed it any number of times over the past several years, extensive changes in 1986 and more changes last year. You know, my basic thought—and I think the President believes this—is still the pond, no more moving, let's let everybody try and work within the laws as they are. But we have made these five recommendations that I set forth this morning. We don't think they are invasive. A good many of them—not all of them, of course—I think will be acceptable to both sides of the aisle.

Senator SYMMS. Do you think you can do anything about the lack of dynamics in the bean counters, both in the Joint Tax Committee and some of them at Treasury, that never seem to give us a dynamic model of what happens if taxes are reduced? We always have to work off static models.

Secretary BRADY. Well, let me say first of all this is the hope that was behind President Bush's suggestion that Chairman Greenspan, the head of the Fed, might be able to shed some light on this. But I think there is an enormous amount of confusion, even among the words. It is my understanding that when you use the word "dynamic" that the estimators do use dynamic estimating. By that they mean they differ as to how those dynamics are applied, and that is the reason why you have these enormously wide differences in scoring methods.

I think what you may be referring to is the so-called macroeconomic view, whereby estimators are asked to see what kind of a feedback effect that would have with the whole economy. Generally speaking, they don't do that because that just widens the argument. But I am hopeful Chairman Greenspan can do something about that.

Mike may want to add to that.

Senator SYMMS. That is what I was going to say. You know, usually Treasury and Joint Tax leave out the potential revenue growth to Treasury. Dr. Boskin, what would you say about that?

Dr. BOSKIN. Well, I think Secretary Brady phrased it exactly correctly. Both the Joint Tax Committee and the Treasury do take account of certain types of behavior. The Joint Tax Committee thinks that changes in realizations that might occur with a lower capital gains rate will be very small—that there will be small additional realizations—while Treasury thinks there will be more additional realizations. If you look at the academic studies that have been done on this, the Treasury is fairly conservative, somewhat below the middle of the studies. The Joint Tax Committee is way at the bottom. Neither of them estimate the feedback effect, as Secretary Brady said, on GNP, higher incomes, higher business and personal income and other types of taxes that would accrue.

Last year, Under Secretary of the Treasury Glauber and I did a preliminary analysis using what might be called the midpoint in each step of the calculation of what might happen with that pro-

posal. We testified before the Finance Committee and had some discussions of that and indicated that there would be a significant feedback effect, in our opinion. That is a subject, obviously, of dispute. The size of the feedback effect, the nature of it, and the timing of it is the subject of professional disagreement, as are the realizations estimates. Therefore, we hope that Chairman Greenspan will help depoliticize this discussion. Under Secretary Glauber and I have tried to be right in the middle of professional opinion in our analysis. We did provide that to the Congress last year. And we do agree with you that not having those effects on GNP revealed is one flaw or shortcoming in the types of information provided to you, in order to help you make decisions about policies that might promote or, alternatively, hinder growth. I would not say that there effects would be easy to estimate. But that is a major flaw.

Senator SYMMS. Thank you very much.

Chairman SASSER. Thank you, Senator Symms.

Senator Exon?

Senator EXON. Mr. Chairman, thank you very much.

Senator DOMENICI. Senator, if you would yield 30 seconds to me and count if off mine?

Senator EXON. Yes.

Senator DOMENICI. Mr. Chairman, I just want to comment on the last question and the last answers, not because I am choosing sides, but I believe everyone here should know that the 4-year agreement that we entered into, called the Economic Summit, has truly made that issue that they are discussing enormously important in terms of what we can do and can't do. I am not saying who is right. But now, under this agreement, you have to rely on one group to tell you the 4-year effects of a tax, and if it is off the mark, you can't do it. That becomes very, very important, because if it is wrong, it is effectively gone because you need 60 votes. So it has become a very important issue as to how accurate the estimating of outyear, second, third, fourth year effects of tax changes are.

Thank you very much, and thank you, Senator Exon.

Senator EXON. Gentlemen, welcome to you. I listened with great interest to your statements about the tax code. As I take it, you are both saying here today you just think that, regardless of the pressures pro and con, the tax code should be left the way it is. Is that what you are saying?

Secretary BRADY. Well, what we said was it is the time to settle and let people work with the tax code. This morning, Senator Exon, I gave five places that I thought would not be too invasive. There may be others, and I think some of those are ones that both sides of the aisle agree to; some of them aren't.

Senator EXON. Leaving the tax code alone, does that also reflect your view that we should not be getting into the capital gains situation at the present time?

Secretary BRADY. Senator Exon, among my five recommendations, the capital gains tax was included, and as you have probably noticed, it is in the President's budget. The revenues from that capital gains tax cut, which the Treasury estimates are about $9 billion, are not necessary to meet the Gramm-Rudman targets, though. We can meet them without those revenues.

Senator EXON. Which is another way of saying what?

Secretary BRADY. It is another way of saying what I said, sir. You know, I don't have any further comments than that.

Senator EXON. You believe that over a 4-year period a cut in the capital gains tax would yield more in revenue?

Secretary BRADY. I believe it will yield in revenue about $9.1 billion, which is what the Treasury Office of Tax Analysis estimated. Those figures are in the budget.

Senator EXON. Over a 4-year period, right?

Secretary BRADY. Over a 5-year period.

Senator EXON. Five-year period.

Dr. Boskin, your projections about the return to a more positive economy in the second half of the calendar year, I think—or is that the fiscal year?

Dr. BOSKIN. Calendar year, sir.

Senator EXON. Calendar year. Would that still be your assumption if the war would drag on? I assume that you are saying it now with the assumption that the war is likely to end sometime this spring and not drag into next fall. If the war would drag into next fall, would that significantly change your projections?

Dr. BOSKIN. Probably not. It would obviously depend on circumstances. If it was clear that the oil supplies were safe and were not going to be disrupted, as it appeared right after the first night of Desert Storm, and if there is for some reason a long mopup operation that continues, I think the effect would be rather minimal. There would be some small incremental spending——

Senator EXON. I am not talking about mopup operations. I am talking about being in the same situation in October that we are in today. Would that change your projection?

Dr. BOSKIN. Excuse me. I misunderstood your question. If that was the case, it would depend heavily on what happened to consumer and business confidence. As oil prices stay down and as it was clear that the Iraqis don't have the ability to disrupt world oil supplies, these factors and some other factors, will help lead to a strengthening in consumer confidence. So I don't think it would have a major impact.

Senator EXON. Therefore, you are also saying that you don't believe that carrying on the war as we are carrying it on right now would significantly add to our budget woes? Or do the budget woes have anything to do with the economy whatsoever?

Dr. BOSKIN. Sure they do. As best as I can determine—and Secretary Brady, who has been intimately involved in this might care to comment—a large percentage of the cost of Desert Storm has been picked up by our allies, and the direct budgetary costs have been rather modest. There are $15 billion of outlays included currently, and there are $51 billion of commitments from our allies. So unless something radically changed that, I wouldn't see a major impact on the budget.

Senator EXON. That is good news. I hope it comes true.

Let me go back, Mr. Secretary, to the whole proposition that you have outlined. Congratulations for taking on the banking problem. I know it is a very troubling one to all of us. I am very much concerned about what I suspect is going to be the end result, if it comes to pass, of the big getting bigger. Branch banking from the

national level is going to have great stress, it seems to me, on the smaller banks and the smaller communities and the smaller States.

I am very much concerned about the fact of letting the banks get into the securities business. A few years ago, when I was glad to serve with you here as a colleague, I was standing by the Associated Press machine one day, and I asked you, as a Wall Street expert, to explain to me why the stock market suddenly went up the same day we announced a significant increase in the national debt. And you said, well, that was a situation where people were putting their mouths and their money behind what was going on.

I have always felt, even more so now than ever, that Wall Street is more like a parimutuel betting track than it is a measurement, as it once was, of the health of the economy on down the road. Does it give you any concern the fact that your proposals would lead the banking industry down a path where they would be more and more involved in that gambling pit up on Wall Street?

Secretary BRADY. No, Senator Exon, not really. I think just the reverse, frankly; that the reforms that we have suggested and changes we have suggested are ones that will make the banking system steadier, stronger, and better able to serve the public. I notice you mentioned in your question and you observed the fact that we are talking about moving towards branch banking across the United States. I would just point out two factors. One is that already in 33 States in the United States, banks can own a subsidiary. So it is simply a question in those 33 States of letting them change from the subsidiary status to the branch status.

Secondly, I would just—I again see the red light, Chairman. Secondly, I would observe a fundamental principle behind the bank reform, which is that the American people are banking in a way that is totally different than the banks are allowed to bank. Everybody has a credit card. Everybody has a money card, so that they can go from Washington to Nebraska, even though you may not be able to own banks between those two States, and they simply just go up to the cash machine and ask for money. Nobody asks them for an I.D. Nobody asks them for a driver's license or their social security number. You put the card in, and out comes the money. That is the way banking works in this country, and we ought to put the laws on the books so that those things are more easy to do. That is the way the public wants it, I think.

Senator EXON. Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Exon.

Senator Lott?

Senator LOTT. Mr. Chairman, I am surprised that Senator Kasten left because I know he probably would want to ask this question. But I will go ahead and ask it in his absence.

What is your reaction and evaluation of the so-called social security payroll tax cut as proposed by Senator Moynihan and Senator Kasten? Would that have a positive impact on the economy in terms of reducing the deficit and creating jobs, the positive things we are looking for?

Secretary BRADY. Let me take a crack and then ask Mike. I will be short, Senator Lott.

First of all, any time you return money to a segment of the population, as that proposal would do, it obviously would be of some

help. I think where we lose is the fact that whether or not the social security trust fund is on or off budget, money coming into that account does provide a place where the U.S. Federal debt is absorbed. So it isn't for free. Any amount of reduction in the social security taxes will, of course, expand the amount of Federal debt that we have to issue to cover the expenses of the Government. So, in my opinion, although it is a darn good idea to examine, I wouldn't do it.

Dr. BOSKIN. Let me just pick up on a couple of Secretary Brady's comments. In an ideal world, it would be wonderful to be able to adopt this. For instance, if we didn't have a large budget deficit now, or if we didn't have rules. But we have rules in the budget law now that try to protect the actuarial balance in social security, following up on the 1983 amendments. Therefore, as I understand the budget law—and, Chairman Sasser or Senator Domenici, correct me if I'm wrong—if revenues are decreased, they must be matched either by an alternative source of revenue or by a reduction in current or future social security benefits. I think that is our concern. We have sympathy for the notion that lower taxes can help stimulate the economy, but for the reasons the Secretary has stated at this time we think it is probably not something we would support.

Senator LOTT. Well, this is an issue obviously we are going to have to talk about a lot more, and we will get into a lot of detail later on. But I wanted to ask you right up front as we discuss the budget what your preliminary reaction would be to it.

There are a couple of things in the President's budget proposal that cause me a good deal of concern. One of them has to do with IRS enforcement revenues. There is a proposal in here to increase funding for an examination field audit initiative and for collection of accounts receivable initiative. Without going into a lot of detail, what evidence do you have that suggests that these initiatives actually are going to raise revenue? As a matter of fact, I think you would be hard pressed to prove that, and I think they actually could have a counter or a negative impact. The general feeling among the people, and I think the Congress, is that IRS compounds the problem instead of really helping it.

Secretary BRADY. Senator Lott, the evidence is that if you put more people and greater resources behind the job of collecting the revenues which are just the revenues that are due—we are not talking about trying to expand any amount of revenues that the IRS is entitled to. I have forgotten the figure now, but there are some $60 or $70 billion that are due the Government that isn't paid. It is a question of if you put more agents on this job, we will get the money that is owed the Government. So I don't think it is an expansion of trying to get money that isn't already due. It is to try to collect that which is already due the Government.

Senator LOTT. Let me go to another question rather than both of you responding to that. I didn't get to do it yesterday, and I need to do it today.

I am very much concerned, also, about the impact the budget proposals would have on agriculture. Agriculture is a very, very important part of the economy of this country. But, it has an

impact other than just on the economy. It is the way people live and the way we eat.

One of the proposals has to do with the Farm Credit System, and I wonder what Treasury's reaction is to OMB's forecast about farm credit. There are proposals in here to reduce the farm credit districts down significantly from 12 to 1 to 5. It talks about a change in the Federal Farm Credit Administration.

I am worried that we are not giving enough attention to what kind of impact it is going to have for farm credit availability. If the farmers don't have it, they don't plant or operate their farms. So I think we need to be very careful about how we go after changes in the Farm Credit Administration.

Secretary BRADY. Well, we have discussed these matters with the OMB, and it is our feeling that the changes that they would be making—although I understand that there is a feeling in the farm community that they don't want any changes, these changes will not affect the effectiveness of farmers in doing their job. But I understand your concern.

Dr. BOSKIN. Senator Lott, this was designed as kind of an efficiency move, as you have indicated. The implementation of it, if it, indeed, is passed, would be designed to make sure that credit does remain available. As you know, the recapitalization of the Farm Credit System several years ago made a major improvement. We understand the problems that farmers face, and these were designed not to reduce the availability of credit or reduce services for farmers, but to try to improve some efficiencies to the best extent available.

Interest is probably one of the biggest expenses farmers face, as you know, and I think that the substantially lower interest rates we have seen now should help, both directly for farmers who are borrowing and also indirectly by increasing the asset values of their farms, because those assests would be capitalized at lower interest rates.

Senator LOTT. Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Lott.

Senator Wirth?

Senator WIRTH. Thank you, Mr. Chairman.

Secretary Brady, I once again want to commend you on the major initiative you are taking on financial institutions with stronger capital standards and earlier intervention and all the rest. I think it is very important, and I hope that we do what Senator Domenici was suggesting and have the opportunity to react to that and do it quite expeditiously.

It seems to me that as we do that there is a preliminary set of decisions that we have to make, and that goes to the Bank Insurance Fund on which you had a brief exchange with Chairman Riegle. It seems to me that that is the most important thing that we have to do right away, to focus on the recapitalization of the Bank Insurance Fund. You have testified to that in the past, to the importance of that, and again this morning. Mr. Seidman has done so. We have heard a great deal of testimony in the Banking Committee about that.

What concerns me is that we do not have a proposal from all of you. We have a set of principles which reminds me of the princi-

ples that we had from you on the S&L issue when we asked you—you remember last fall. You and I have talked about that. We asked the administration over and over and over again for what it was you wanted in the S&L area, and we did not get a response until about a week before the Congress adjourned. I think this issue is so enormously important that we have to get at it right away.

I asked Mr. Seidman about how this ought to be done, and his response was, well, he would be presenting his ideas as part of the administration's overall package for the Bank Insurance Fund. This morning, as you said to Senator Riegle, you were going to await Mr. Seidman.

Now, what we want to do is to get a word from one or the other of you as to what it is you want to do. You said this morning maybe you would have to go up to 50 basis points for insurance. The Congressional Budget Office has testified that we ought to go to 30 basis points over a 3-year period of time and have a line of credit going to the treasury. Could you expand a little bit about what you think the best way to do this is and, maybe most importantly, when we are going to have a proposal from the administration about exactly what it is you would like to see in the Bank Insurance Fund?

Secretary BRADY. Well, Senator Wirth, just in passing, let me say I know you have had this worry before on the RTC matter as to our appearance before Congress. I would only say since that time we have added up our appearances on the funding problem. We appeared 48 times before Congress since the RTC was put into effect on funding.

Secondly——

Senator WIRTH. I am not suggesting, if I might, that you didn't appear on that issue. The question is what did you want on RTC, and until a week before we adjourned, we didn't receive a proposal from you. We had received a number of principles but no specifics. I just want to make sure we don't go through that again this time and that we get a specific proposal from the administration about what it is that you would like us to do on the Bank Insurance Fund.

Secretary BRADY. I understand. Let me just correct one more thing. I said that it can range from 19.5, which it is now, to 50 basis points. I am not suggesting that at all. I am quite clear that if we went to 50 basis points that would be too much. I want to be firmly on the record on that.

However, with regard to your question about the plan, the Bank Insurance Fund is inside the FDIC. They are an independent agency. They were given the authority in the fall of 1990 to come forward with a plan which allowed them to take the cap off bank insurance premiums. And out of courtesy, I am going to wait until Chairman Seidman comes forward with that plan. That is his job, and he says he is going to do it, and I believe he will. And I am told—I asked him the other day the same question. He said it will be during the month of February.

Senator WIRTH. So we will have that sometime in the month of February.

Secretary BRADY. That is what Chairman Seidman told me as recently as 2 days ago.

Senator WIRTH. So we would expect that that would go through the Treasury Department, the administration, and then come to us. Is that right?

Secretary BRADY. Well, I think that is an independent agency. It will come directly to you. But we will have our own comments on it at that particular point in time. And we are working with them at this particular moment. We sit in the meetings, and we have plenty of participation. But it is his job first to come forward with it, and I think out of courtesy he ought to be allowed to do that.

Senator WIRTH. I do not question he has a responsibility to initiate that. As I remember earlier testimony, he had said it had to go through all of you. Is there a budget impact? If he were to propose a line of credit with the Treasury Department, is there a budget impact to that that we should be concerned about? Dr. Boskin, maybe this goes to you.

Dr. BOSKIN. I am not exactly sure of that question. By way of explanation, I believe we already have a $5 billion line of credit that is already in law. I do believe if there were a Treasury borrowing, that it probably is an outlay, but I would have to check that for you. It would also depend, obviously, on how much income there was from the insurance premium increase, which I am sure will be part of this plan.

Senator WIRTH. Dr. Boskin, in the short time remaining, could you comment in any way you think would be appropriately, quickly, on how you think conservation fuel efficiency ought to fit into a national energy plan?

Dr. BOSKIN. Conservation is something that is important, for a variety of reasons, and steps to improve conservation will be included in the National Energy Strategy. But I think I would be remiss if I did not defer to Secretary Watkins, who will be releasing the National Energy Strategy shortly, and there you will see the collective wisdom of the administration led by Secretary Watkins in that regard. But certainly conservation is important.

Senator WIRTH. Thank you, Mr. Chairman. Thank you, Secretary Brady.

Chairman SASSER. Thank you very much, Senator Wirth.

Senator Brown?

Senator BROWN. Thank you, Mr. Chairman.

Mr. Secretary, we appreciate your coming this morning. I wanted to follow up on a question that the chairman had raised, which I thought it made an excellent point. The question involves charging premiums on foreign deposits in U.S. banks.

You made an interesting point in observing that those deposits often can be swayed by a very small change in interest rates and that there could be an impact on the competitiveness of our banking system in attracting those deposits, if indeed you imposed that higher fee.

Mr. Secretary, doesn't that logic apply to U.S. deposits? In other words, would not U.S. deposits be impacted by the fee that is imposed on them, and would they not be likely to go overseas, just as much as overseas deposits come here?

Secretary BRADY. Senator Brown, I don't think so. I mean the foreign deposits which exist in centers such as London—which is the primary center, but certainly other ones, Paris, Bonn and Tokyo—are enormously sensitive to what the depositor gets in the way of a return from the bank. And an imposition of a deposit fee on those deposits would, in our opinion, scare those deposits out of U.S. banks—where they are available for our internal purposes in the United States—and into foreign banks, and that is just the reverse effect we want to have.

Although an increase in the deposit insurance premium in the United States on domestic deposits will have an effect on banks, it will not have that same effect.

Senator BROWN. Let me try again. You suggested to us that imposing this fee may well impact the desirability of leaving foreign funds in the United States.

Secretary BRADY. No. What I said was those are foreign deposits and they are held outside the United States, but they are in our banks. Since other countries do not have this exact form of deposit insurance premium and there is no such premium on foreign deposits, the imposition of it would raise the cost to our banks and make them less competitive with the banks around the world that we are competing with. And as I showed in a slide yesterday, at this point in time, out of the 30 top banks in the world, we have only one, number 27 on a list of 30, Citicorp. Twenty years ago, we had 9 in that first 30, and the top 3 were U.S. banks.

Senator BROWN. I appreciate what you are saying. I was hoping to get you to comment, though, on my question. My question was whether or not the existence of that fund on U.S. deposits does not make it less desirable for American depositors to hold their funds in U.S. banks. In other words, does not the same logic apply to American depositors?

Secretary BRADY. I do not really think so, because that area of competition is among domestic banks and it is pretty much the same for all of them.

Senator BROWN. I know you have extensive experience in business and in banking. I have some experience in that area. Our operations involved banking both in the United States and overseas. We had options of whether we held deposits in the United States or overseas. I would merely suggest to you that to raise the question of competitiveness and ability to attract deposits is the determining point as to whether we apply that fee to foreign deposits. I think that lacks a certain logic and lacks a certain consistency, because it seems to me that same argument applies to American deposits.

Secretary BRADY. Well, we may just disagree on this effect, and I am sorry if we do. I mentioned one other matter, which is we have a Federal Reserve study which shows that the larger—excuse me, I am off on another subject, I was——

Senator BROWN. Let me, if I could——

Secretary BRADY. No, it was the right subject, that these deposits exist in the larger banks. They are not in the local banks, in the country banks. So, it is important to understand that the imposition of a premium on those deposits would increase the amount of burden on the larger banks, and they already pay 70.7 percent of

the assessments right now. And over time the cost of resolutions in those larger banks has only been 51.5 percent.

Senator BROWN. I thought that was a very significant statistic and I think appropriate for this. Let me ask, in that regard, of the forecast problems—I think our attention is drawn perhaps because of the media to some of the larger banks, because of their third world loans—but of the potential problem in the future, do you see that statistic holding, or do you think we are more likely to see the large money center banks play a bigger role in the deficiencies that might occur in the coming years?

Secretary BRADY. At this particular moment, a great deal of the concern is in the larger banks, but these statistics are ones that existed between 1985 and 1989. They do not include the Bank of New England, which had to be resolved within the last month. But I am told by those people who have looked at the statistics that they do not change it very much.

Senator BROWN. Thank you.

Chairman SASSER. Thank you very much.

Senator Lautenberg?

Senator LAUTENBERG. Thank you very much, Mr. Chairman.

Welcome, Secretary Brady and Dr. Boskin. As the chairman noted, Secretary Brady had the Senate seat I sit in. Frankly, these days I would rather sit on this side asking you the questions than on your side answering them.

Mr. Secretary, I do want to compliment you on the job I think pretty well done, if I might use the term, in extracting support for the Persian Gulf effort from those who stand to benefit substantially from it. It would be tempting to go into a tirade about how much America is going to pay, not only in loss of life, casualties, and financial, et cetera, but I think that getting a commitment is so important, and one of the things that I am concerned about is the quality of those pledges.

Secretary BRADY. Quality of?

Senator LAUTENBERG. Quality of the pledges from our friends and allies. We know that, with no exception, they have the capacity to pay, although I think there has been some foot-dragging in the initial pledges and the target dates for paying them. I think Saudi Arabia is one of those.

If we get any kind of delinquency there, to use commercial terms, in those receivables, we will be incurring extra interest costs, and I wonder, as you go through the projections for the recession or for next year's budget, whether or not, in fact, we do recognize the cost of the war. Though we do not account for it in traditional budgeting fashion, certainly there are interest costs, because we have to borrow money to sustain the effort.

Can I ask you, Mr. Secretary, for any comment on that? Do we have a schedule? I know that there is a target date for making those payments, but is there anything that we can do to make sure that those dates are met, anything that gives you a high level of confidence that they will be better met than we have seen in 1990?

Secretary BRADY. Senator, I can tell you that this is a matter of daily concern in the Treasury. There is an inter-agency group that includes all of the relevant agencies—State, OMB, NSC, ourselves—to make sure that the billing process is up to date. In sever-

al instances, because of the fact that the Defense Department was focusing on the kind of equipment that they wanted in kind, those lists have not been out there as quick as they should be, but that situation is being rectified.

I would only say with regard to 1990, and I am not making a prediction we will do as well in 1991. We hope we will. We have got commitments out there that we think will get that job done. But in 1990, of the $11 billion that Desert Shield cost, we had commitments for $9.7 billion. I think Dick Darman went over some of these figures yesterday, and I do not mean to take your time and repeat them, but that is 88 percent of the cost.

Now, you are exactly right, some of them have not come in on time, and you have said that Saudi Arabia is one of them and that is the biggest one. Japan is one and Germany is one, as well, and we fully expect that these commitments will be kept. In fact, with regard to the Japanese commitment, there is money coming in this week or tomorrow morning that would bring——

Senator LAUTENBERG. It might be a good idea to make those public in some way. I think it would help.

Secretary BRADY. I think Dick Darman said yesterday he was going to try and get some schedule up to this committee on an ongoing basis, Senator, that you all could look at.

Senator LAUTENBERG. Thank you very much.

Dr. Boskin, your estimate, your forecasts on the length and the depth of the recession apparently are agreed to by the stock market, as I look in wonderment at the performance of some of the stocks, better than the companies. You seem to be in sync, but I just wonder about the contingencies that might arise from having additional burdens placed on the economy. Is there any provision for contingencies that might arise from having to fund further the RTC or the FDIC—and I know we had a long discussion about it—or additional unemployment compensation, a reduction in revenues. Also, did you include a capital gains reduction in your forecast?

Dr. BOSKIN. First of all, in the budget, there was a capital gains reduction proposed, the restoration of a differential proposed, and, as Secretary Brady testified earlier, there was an estimate of revenues from that over the 5 years of, I believe, $9.1 billion. But the President's budget satisfies all of the necessary features of the budget law, even if the capital gains proposal is not passed or if revenue gains are counted as zero. So, the capital gains proposal is not being counted upon to fund some things that are already there.

In the budget itself, we do forecast a recession and a rise in unemployment and so on. These forecasts are directly accounted for in the relevant accounts. For instance, the reduction in receipts based on the different revenues forecast by the Treasury—indeed, specifically by the gentleman right behind Secretary Brady here—and the increases in some of the social expenditures are already included.

With respect to contingencies, I will just repeat what I said in response to Senator Riegle's question. The President's advisors, including Secretary Brady, myself, Director Darman and others, routinely analyze what is going on in the economy, what might

happen, and what impact the economy might have on the budget, on people, and on various programs.

We do that when the economy is doing well, as well as when it is doing poorly, as right now. We have included in the budget a detailed set of scenarios that are somewhat more optimistic than our baseline scenario. The main numbers in the baseline scenario are almost identical to the consensus of the blue chip private forecasters, and it is somewhat less optimistic than the CBO.

We have one scenario where we come out of the recession a little sooner, and one where the recession is deeper and longer lasting. And we show the impact on the budget deficit, and so on. So, this proceeds in the normal course of our work.

Chairman SASSER. Thank you.

Senator LAUTENBERG. May I ask unanimous consent for one minute more, Mr. Chairman, since——

Chairman SASSER. Any objection? No objection.

Senator LAUTENBERG. I am introducing a program that proposes IRA availability penalty-free for those burdened by severe unemployment. We are now providing for IRA withdrawals, at least recommending for first-time home ownership, and I agree with that. There is a proposal out there that suggests maybe IRA penalty-free withdrawal for excessive medical expense.

I wonder whether it would not be consistent with trying to stimulate or encourage the economy, relieve some of the tensions, to have IRA penalty-free withdrawals for a period of compensation for a period of unemployment, when compensation might not be available. Do you have a reaction to that?

Secretary BRADY. Yes, Senator. First of all, the goal is entirely worthy. It also brings up the question: if you did it for unemployment, would you also do it for catastrophic illness and a series of other things which are equally concerning.

When we got into that problem and trying to think through the construction of what we have put forward here, we decided we could not enumerate, we could not stop the migration. Once you started with unemployment, to catastrophic, to some other cause, it became awfully hard to see which human concern we could rule out. So, we stopped at the area of savings. Since the IRA is a saving document and since the purchase of the home is also a form of saving, we thought we ought to stop there. But it was not a lack of concern for the problem you have brought forward.

Senator LAUTENBERG. Thank you very much, Mr. Chairman.

Chairman SASSER. Thank you, Senator Lautenberg. We are pleased to have you go over there for a minute.

Senator Nickles?

Senator NICKLES. Mr. Chairman, thank you very much, and to both of our guests and panelists.

Secretary Brady, I was reviewing the proposal dealing with your deposit insurance and banking reforms, and it has been discussed by other members of the committee. I want to compliment you on most of everything I have seen in the package. I think your elimination of coverage for brokered deposits—I had a meeting with bankers in Oklahoma, actually two meetings—three, I had two meetings with bankers and one meeting with S&L's—I heard elimination of coverage of brokered deposits was high on everybody's list

for reform. You have several other reforms that were mentioned time and time again that needed to be done, the capital based supervision, risk-related adjusted premiums, I guess make eminent good sense.

You have reduced coverage on multiple insured accounts. I would agree with that. I think you are going to have a real problem, though, if you start trying to make the $100,000 limit per individual nationwide. To implement that, it is going to be very, very difficult. A lot of people do have multiple accounts in multiple institutions. It might be quite costly to try to implement that. I am quite open to it, if it can be done in a nonbureaucratic way, without costing more than it would resolve, but that remains to be seen.

Other of my colleagues have mentioned foreign deposits, but let me just make one comment. In the last several years, the FDIC has been, in effect, insuring a lot of deposits that are not paying premiums. We have been insuring deposits on big banks, the so-called "too-big-to-fail" doctrine, and we have been insuring foreign deposits, neither of which have contributed anything towards the FDIC, and so the net result is I think doomed for failure. I know, at least, in looking at the initial outline, it says no assessment on foreign deposits, and I question whether or not you are adequately addressing "too-big-to-fail."

As long as we continue to cover and insure deposits which are not paying premiums, you are putting a real inequity into the system, inequity for those people who are paying 100 percent premium on those deposits and receiving that amount of insurance, compared to those banks or systems that receive 100 percent coverage, even though they do not pay that kind of premium.

I think that is an issue of equity. I know it has been addressed by other colleagues. I have heard your statement, and I am concerned about it. I do not want to run foreign deposits off, either, but I think Senator Brown made a good point. These marginal increases in premiums for insurance, if that would scare away foreign deposits, I think Senator Brown has a point. I think to some extent it will scare off domestic deposits, so maybe that is the reason why we only have one bank in the top 30, I am not sure, but we need to look at that as well, and we need to address the "too-big-to-fail" doctrine.

You don't have what I would call cost sharing in this. I think that would be a big move towards market discipline, where investors have to share some risk. Maybe that risk would be 2 percent above $50,000 on the next $50,000. I do not know that the risk would have to be significant to instil some discipline.

Again, I compliment you on much of the proposal. You have several pages of some extended powers, et cetera. I think a lot of it makes eminent good sense. Allowing other outside industrial firms to come in and purchase failing institutions—I think a lot of these really do work towards solving the problem, but I really think we have to address the fact that we have been insuring uninsured deposits and that is going to break the system, and unless we solve that problem, I am not sure it will be a satisfactory solution.

Secretary BRADY. Could I reply just for a minute?

Senator NICKLES. Please.

Secretary BRADY. Senator Nickles, you put your finger on the age-old question that has always been one of enormous concern to the industry and observers, what is called "too-big-to-fail." I like to call it "too-important-to-the-system-to-fail" or "too-vital-to-the-system-to-fail," because what we are talking about is making sure that the system holds up in moments of stress.

Let me just say what we think our plan does. First of all, we think that if it was adopted, it would put enormous strength into the industry. This is a statistic I should have brought out earlier, but the leading consultant on the banking industry estimates that the repeal of the McFadden law, which deals with interstate banking, which would allow interstate branching, would add in the fifth year between $5 and $10 billion to the income stream of the banking industry. That is an enormous figure, when you figure that the after-tax profits for the industry last year were some $20 billion.

Our initial checks of his estimates cannot be complete, but we see some real savings there—$5 to $10 billion is an enormous figure, and to me would start to flesh out what we think is the strength behind our proposal, which is a banking industry where you don't have failures. Then we will not have to deal with the "too-big-to-fail." We are the only country in the world that has got this problem. You do not read about Japanese, German, French, and British banks failing. This is right in the United States, so in my mind we must be doing something wrong and our plan is part of the correction of that:

Number one, make the industry stronger; number two, our plan calls for early intervention, instead of waiting until a bank hits the zero line, to get in there when they get down below the 8 percent capital ratio and get at it right away and make sure that they have to make some changes at that particular time.

Thirdly, the emphasis on if the profitability of the industry improved, then it will attract capital; capital will come in itself. We have the provision that you referred to, which is allow industrial companies to come in, but maybe we will not have to wait for that, if the industry itself earns more. That is what we feel is the answer to the "too-big-to-fail" problem. It is an enormously significant question.

Senator NICKLES. I compliment you. I hope we are successful in improving the financial health of banks. I do not like reading where small banks are going upside-down, and I do not like reading where the big banks are laying off thousands of people, and I think many of us know that they have some questionable quality loans of third world countries, et cetera. Some of it our government has encouraged them to make. But I still think we really do need to address the fact that a lot of those deposits are, in effect, being insured and they are not paying insurance, and that is not a healthy or equitable situation for the banking industry.

Thank you.

Chairman SASSER. Thank you, Senator Nickles.

I might say I agree with your statement, Senator Nickles, and I would encourage you to look at a bill that Senator Dole and I have introduced that deals with this problem. You might find it of great interest.

Senator Domenici, we have been waiting with great interest all morning for your questions.

Senator DOMENICI. I have been having a good time listening, but I want to comment first.

Mr. Secretary, if there is one thing we are hearing at every meeting with business people and from fellow Senators, it is the issue that you have answered, and that has to do with why banks are not lending money, and there are a lot of reasons being bantered around.

One that is very common is that the regulators have scared them off and that, indeed, some loans are being called that are good loans. Did I hear you correctly, in response to some one's question—it might have been the opening questioner, Kit Bond—that you, as Secretary of the Treasury, with others that regulate the banks, are now looking at this issue so that, instead of us just hearing the rumors around and the contentions, we are going to get some answers. You are going to come up with some objective analysis with reference to this? Is that correct?

Secretary BRADY. That is correct, Senator Domenici. You say "are now." I would only quarrel with the "now." We have been doing that for several months now, and Deputy Secretary Robson has been chairing a group that meets several times a week on this subject, and we have some specific, precise regulations that we are looking at. And I think you will be pleased with the precision or the preciseness of our inquiries, as opposed to just a general lament, which is so hard to deal with, as you know.

Let me just say one more thing, and then I will be quiet. I think it is important that the regulators and the administration take the fifth step, because the question still exists as to whether the lack of loans is the fault of the regulators or the banks themselves. So we just simply decided we will do our job and then we will find out whose responsibility it is.

Senator DOMENICI. I just want to tell you, and I want to share this with the chairman, about 2½ years ago I was up in the northeast United States, in New Hampshire or one of the adjoining States, and a big question just before the presidential election was what will President Bush do when he goes in office to see to it that the cost of housing comes down. They did not want to know anything about anything else, just how will he lower the cost of housing. I had no way of telling him how he could do that, except that interest rates came down. Frankly, the people asking the questions did not understand that interest rates had anything to do with the cost of housing.

I went up there very recently and we have got things turned on its head now. The cost of housing is coming down precipitously, and there are some who believe that there is a free-fall in real estate in the United States. Could I ask both of you, do you think there is?

Dr. BOSKIN. No, I think there have been substantial declines in real estate values, especially in certain areas, New England, New York, parts of California, for example. I think they tend to be regionally focused. There are obviously a variety of reasons for this. One of them has to do with banking lending, and also some of it has to do with the ratio of building to demand.

I would not describe prices currently as in a free-fall, but I do believe there has been a substantial decline in real estate values. I do believe if the the types of things that the Treasury Department has taken the lead in trying to correct are not corrected, then you run the risk of a further decline.

Senator DOMENICI. Mr. Secretary, I do not want a long discussion of this because I do not have much time either and I am sure you do not. But let me just ask you, on this issue of real estate values. Some are suggesting—and I am just not informed enough to know—that this recession might be different because of this issue. Because the assets underpinning much of the liability or debt around—and the debt was very excessive on all fronts—that if the asset underlying it, to wit, real estate, continues to drop in value, we may have a very different situation than the recessions since the 1920's. Is there anything to this? Does it concern you? Or do you think we are just in a process of readjusting real estate values?

Secretary BRADY. Like all questions, Senator Domenici, I think the recession is multifaceted. Certainly the increase in the price of oil and the war in the gulf has quite a lot to do with it. But certainly real estate is an enormously big part of it. Somebody said that 80 percent of the average American's net worth is in his home. So if the average American sees the price of his home coming down, that has to affect his confidence level. I think that, plus the oil and the Middle East, is the reason why you have this precipitous drop in the confidence statistics that we see.

So the answer is, yes. It is different, but to an extent, each recession has some different phase to it. I think if we can get the Middle East behind us then we will have certainly made a big knock on that. I would, of course, like to see lower interest rates, as I know you would.

Senator DOMENICI. The reason I think the question is terribly relevant is because we see some peculiar signs out there. We have the cost of money coming down because of the Federal Reserve and we do ot see a corresponding impact on interest rates from the banks. It does concern many of us because that used to be our principal stimulus. When we got into one of these we would push hard and interest rates would come down.

The converse was true in the last great recession. Paul Volcker did the opposite. He held them up and if they started coming down he put them back up so he could wring out inflation. He might have gone on too long—maybe a year too long some people say.

But why is the response not there now, Mr. Boskin?

Dr. BOSKIN. There has been some response, Senator Domenici. The prime has fallen to 9 percent and it is expected to continue to decline some. But there is a lag, and the spread between the banks cost of funds and the lending rate certainly is large by historic standards. That is correct. It has also been true that despite the Fed's actions, money growth has remained low. And Chairman Greenspan and others have indicated that this is a prime source of concern. They want to make sure there is more money and credit available in the system.

Probably part of the reason why the spreads have widened had to do with the profitability problems the banks had and the requirement that they raise their capital ratios: the ratio of their

equity to their assets. And at a very difficult time to attract outside capital, I think many of them were just trying to do the best they could to retain earnings. The competition that is generally engendered, and certainly that would be enhanced by the proposals Treasury put forward yesterday, should get those spreads to more normal levels over time.

Senator DOMENICI. Let me just tell you both, this is not a private discussion between us. In the papers of New Mexico, each time that the Federal Reserve lowered the discount rate the leaders of the banking industry were asked, will interest rates come down? Both times, the major banks in our State said no. People did not like that so they said, why? The bankers said, because we are not making enough money as it is. We have had to write off loans, and the regulators, changes in regulations, and increased premiums that we have to pay do not justify us reducing the interest rates. Is that what you are saying?

Dr. BOSKIN. Yes, that they are using that higher spread to cover costs and other things, including responses to regulatory—

Senator DOMENICI. You assume we will get down to an interest rate sooner or later that will cause the prime to come down?

Dr. BOSKIN. Yes.

Senator DOMENICI. Substantially.

Dr. BOSKIN. I believe that as these issues are worked out, as some of the things that Deputy Secretary Robson is working on, start to permeate through the system, the rates that borrowers actually borrow at long term loans and mortgages, for example, will come down. They have come down some. I think this is what you are getting at, Senator. It is not sufficient for the prime rate to come down, for example, if the credit is not available at the prime rate. The bank can post any interest rate it wants. But, if creditworthy borrowers show up and banks turn down the loan, it is as if the interest rate is infinite. It does not matter.

Senator DOMENICI. Secretary Brady, I have a parochial question. I am not going to ask it. I am going to put it in the record, but I hope you and your staff will answer it quickly because I think although it came from my municipal league with reference to cities and the changes we have just imposed in the last budget agreement on social security tax collections. I hope you will answer it quickly, and I will not ask you it now. Every city is beginning to wonder about your regulations regarding that. And I do not need to use any time now.

My second one is equally important, Mr. Secretary, and I am not going to use the chairman's time on it either. But you know that we went to great ends to put in some tax incentives for the oil industry, for those who are trying to produce oil. One that I worked on for 2 years has to do with enhanced oil recovery, EOR. Now I do not know whether the people in Treasury like it or do not like it, but we did pass a very significant—essentially, a 15-percent—credit to get oil out of the ground that is already found. It is not drilling new wells. It is there, but we cannot get it out because it requires extraordinary efforts. That is why it is called enhanced oil recovery.

We need the regulations quickly on what technologies are included in that. In 1979 we knew what they were. We got rid of the law.

Now everybody is waiting before they invest, Mr. Secretary, to see if the technology they are going to use fits or not. I do not expect you to answer it now, but when it comes to you in writing you can reply. I hope you know that most experts say the most significant source of new oil in the United States—in the continental United States—is what is already discovered. It is sitting there and we do not take it out. We leave 65 to 70 percent of the oil in the ground all the time, in every well, and it is out there. There are no environmental problems. We ought to go get it out.

So if you would consider that an important issue because I think it is. We will give you the question in writing so it will be very precise.

Secretary BRADY. We will make sure and get you the answers promptly.

Senator DOMENICI. Now, Mr. Secretary and Economic Adviser to the President, much has been asked of you today about what should be done to help those who are feeling the recession and to help get us out of it. We have a lot of built in economic stabilizers: unemployment compensation and food stamps, for example, and a number of other programs. We have got to be sure that is work. But I want to ask on the other side. Are either of you looking at anything that we are not doing in the United States as a matter of policy so that we will keep the American economy growing once it starts up again?

Let me give you an example, Mr. Secretary. Why are we not publicly debating the issue of double taxation of corporate dividends? We are discussing capital gains, which is clearly an important issue. But this Senator feels that double taxation is one of the reasons we have so much borrowing in the corporate arena and so many takeovers with borrowed money. I believe a substantial portion of these activities is explained by the tax code which makes them more economic. You write off every bit of interest. But when it comes to corporate financing on the equity side, you do not write off anything and then you get taxed twice. You get taxed on the profit and then you get taxed on the dividends.

I just think those kinds of things ought to be studied and promoted, even if it is difficult getting them done. Are you studying that kind of thing and what do you think of that specific change at this moment?

Secretary BRADY. Senator Domenici, the study that you are talking about is underway and I would hope it can be presented this year. It is an enormously complex problem. The basic fundamental problem is that if you eliminate the double taxation of dividends—which is a darn good idea and would do the things that you have just suggested—it has a substantial effect on the budget revenues. Therefore, you are caught in the same old bind that we have all been trying to wrestle with these many years.

So the problem is to come out with some sort of a balance that takes care of the inequities in the system that you have talked about, at the same time that we do not decrease the revenues to the Government at a time when we already have a large deficit. It is a mathematical problem that is very hard to come to resolution on.

Senator DOMENICI. Let me just give you my thoughts. I understand all that and I compliment you because I do not think I am stating anything original. I think I read about 8 months ago where you said something similar to what I just said. You might have said it much more clearly and much more precisely, but I believe you said it.

Secretary BRADY. I doubt it.

Senator DOMENICI. Mr. Chairman, I have one last question. Mr. Secretary, let me tell you a haunting set of facts about the S&L crisis, because I think we must look at this kind of thing carefully as we reform the banking industry. I have been informed, and the chairman knows even more about this issue than I, that 70 percent of the cost of the S&L failures came from two States, Texas and California. And that same 70 percent came from the bankruptcy of State-chartered savings and loans.

We permitted State-chartered S&L's to get exactly the same guarantees by the taxpayers of the United States as federally chartered S&L's. But State-chartered S&L's were more risky as it turns out. No question about it. For instance, they had no limitation on the number of junk bonds that could be held in their underlying portfolio. Federally chartered ones did.

The $100,000 guarantee misdirected investments and sensitized people to invest where there was a big difference in the risk. And we made no differentiation in behalf of the taxpayers of the United States. I think all those are facts.

We will soon have, Mr. Secretary, a Congressional Budget Office evaluation of the impact on our economy of these guarantees. It is going to try to tell us whether we had wrong incentives that caused the misdirection of investments. I assume you would be interested in that, would you not?

Secretary BRADY. Very much so.

Senator DOMENICI. With regard to your reform plan for the banks of this country, are you moving in the direction of seeing to it that we minimize the ultimate liability of the taxpayer and the opportunity for this kind of thing to happen again?

Secretary BRADY. Absolutely, Senator Domenici. There is a prohibition in our submission, in our report, for Federal guarantees for what we call risky State bank activity. This is not going to be allowed, period.

Senator DOMENICI. So we are going to have a level playing field: equal premiums for the same risk, as best we can define the risk and regulate it?

Secretary BRADY. That is accurate.

Senator DOMENICI. Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Domenici.

Dr. Boskin, we have lost 232,000 jobs in January. One of the leading Wall Street brokerage firms put out this economic commentary this week. They stated, "the optimistic case that the recession will be brief was blown out of the water by the plunge in January employment. In any case, the current downturn can hardly be characterized as mild."

Now that is what they are saying. You have indicated that the Fed has reduced rates, but I do not see any signs of recovery in the interest rate sector so far, particularly in the case of automobile

sales. Apparently, General Motors agrees. They have slashed their dividends. They have slashed production. They are laying off people. In the construction area, housing remains depressed. I have seen reports that say we have got enough commercial office space in this country to last to the beginning of the next century.

Now I am familiar with the argument about natural stabilizers that are built in, and my friend Senator Domenici alluded to some of those just a moment ago. But two-thirds of the people who are unemployed do not receive benefits. And many of those who do receive benefits are having to wait 6 or 7 weeks to get those benefits. So I do not see these stabilizers working as well as they should.

I was really disturbed to read this morning in the paper about tumbling auto sales and weak factory order reports that appeared just this morning. In view of that, where do you get your confidence that this is going to be a mild recession, that we are going to have an upturn here in the spring?

Dr. BOSKIN. Senator, our forecast had an even larger decline in the fourth quarter, 3.4 percent at an annual rate, than actually occurred—the 2.1 percent preliminary Commerce Department estimate. We believe that some of that is spilling over into the first quarter and that the first quarter decline will be a little larger to compensate for the fourth quarter decline being a little smaller.

You are quite correct that the interest-sensitive sectors you have indicated, automobiles and construction, are in very weak shape and have not yet rebounded. Usually after interest rates make a sizeable decline it takes two or three quarters for the interest rate changes to begin to affect the economy. So for this particular reason, and for the many that I mentioned earlier, one would be forecasting some turnaround around the middle of the year in these sectors. I do not predict that they will become as robust as they were a couple of years ago, but they have been declining and we do expect that to level out. Then for these sectors should begin to rebound by the middle of the year.

Chairman SASSER. I will just say this and wrap it up. One of my real concerns is that we simply do not have the tools to deal with the problem of a recessionary economy we have had in times past. We do not have the fiscal tools that we have had in times past because of the very large budget deficit. That is really why I urged on the administration within weeks after the President was sworn in, we needed to get a budget agreement at that time. I am glad we finally got one. I am afraid that it came a year too late, or certainly it would have been much better had it come a year earlier.

But we do not have the fiscal tools to initiate the counter-cyclical policy that we used to initiate in times past. I am familiar with the arguments that say that comes too late. But even if that is correct, the fact that those countercyclical policies were coming were confidence-builders out there for consumers and investors, and certainly stimulated us or accelerated coming out of the trough when they finally came along. They are not available to us.

Now our only recourse is monetary policy. We are looking to the Fed and we are saying, they have got to bring the rates down. I agree with you and your statement, they do have to bring them down and they have to bring them down faster. But my concern is we are not seeing any result of that. Senator Domenici says the

banks in his State say, we cannot reduce our rates because of profit pressures on us. Then we see the general skittishness on the parts of the banks to move forward and make additional loans.

Does this concern you and does this give you some pause that we might be looking at a more dangerous recession than we have anticipated based on historical data from other recessions in post-World War II?

Dr. BOSKIN. As Secretary Brady indicated, each recession has some unique features and the issues with respect to real estate and banking are relatively unique in this one relative to others. As I indicated in my opening remarks, one of the downside risks is the availability of credit and the problems in these sectors. And we did present a lower growth scenario which has a deeper and longer lasting recession. And we presented its impact on the budget deficit. So that is certainly a possibility. I still do not believe it is the most likely thing, but it certainly cannot be ruled out. Just as a more rapid recovery, as projected by the CBO, can not be ruled out.

I do believe that one aspect of the automatic stabilizers is worth mentioning. There is about $40 billion in our baseline this year and about $50 billion next year (in round numbers). A lot of this is the natural slowdown in tax revenues, in corporate profits taxes, and personal income and payroll taxes as we head into a downturn. That also cushions the decline in after-tax income and spending.

There are many studies that have been done about the effectiveness of what you mentioned, sir—discretionary fiscal policy: putting on and off investment tax credits and increases in spending programs, some of which occurred in previous downturns. These studies come to very mixed conclusions. Some of them conclude that by the time the policies are actually in place the economy had recovered by itself. Then these programs were very difficult to unwind and kept going. Other studies conclude that they were somewhat more successful. So I think the evidence on that is mixed.

Chairman SASSER. Yes. The question of risk-based premiums, which is something that, as I indicated earlier, Mr. Secretary, I support. What about the argument that risk-based premiums is going to have a chilling effect on the banks moving forward with additional lending at a critical time when they need to be more generous in their lending policies?

Secretary BRADY. Senator Sasser, I think that that is a worthwhile concern and it is the reason why we approach the risk-based premium part of the plan on a phased-in basis. We think that it should not be put in right away and that any widening of the competitive disadvantage to some of the banks that are on the lower end of profitability have with the more profitable ones is not very smart to do at this particular time. But we think, as do you, that it is a good basic principle and that we ought to move towards it. But it will not happen right away.

Chairman SASSER. This is my final question and I will address this to both of you. I think we all want the Fed to lower rates more and I have said that for a long time and I was saying it last year. That if the Fed did not come down and lower rates, then the Fed and their policy were going to be instrumental in pushing us over the edge—I was saying that last summer.

But the question comes, how much latitude does Dr. Greenspan and the Federal Reserve have? As they bring these rates down, we are seeing that the Germans are taking their rates up. We have got to attract this foreign capital to help finance this deficit.

Now I wish one or both of you would address that problem. How much latitude does the Fed have in lowering these rates? How far can they go until we get an exodus of capital that we need here to finance not only our deficit but also, perhaps, to finance internal domestic development?

Secretary BRADY. That may, of course, have been the reason that rates should have been allowed to come down faster before we got into this contradiction that you have put forward. It is the reason why some of us have been urging the Fed to move faster much, much earlier in the year, just because we did not want to get into this box. It was quite clear that the Germans were going to have to raise interest rates at some point in time, because the cost of unification is such that their deficit has gone from 40 billion Deutsche marks last year, to 100 this year, up to 140 next year. So those tea leaves were in the tea cup for quite some period of time.

I do feel that the level of the dollar has been reasonably stable over the last several months. It has weakened a little bit in the last week or so. But I think this is a problem that we can overcome and still have a sufficient amount of investment from abroad to make sure that our needs are met at the lowest cost possible.

Dr. BOSKIN. I agree with everything Secretary Brady said. I would just make one additional comment. One concern that investors, domestic or foreign, have concerns the future course of inflation. If they believe a monetary policy——

Chairman SASSER. I might say, you must have said something of great import there, Mr. Secretary. All the press just got up and rushed out of the room.

Secretary BRADY. I cannot imagine what it was.

Chairman SASSER. Excuse me, Dr. Boskin. Go ahead.

Dr. BOSKIN. The wire services usually trample the chairs at times like that. In addition to the points that Secretary Brady raised, I would just reiterate something I alluded to in my introductory remarks. One concern investors have when they see the Fed trying to bring interest rates down and trying to ease money and credit is a concern about future inflation. What we have seen is that after several years of relatively steady and much lower inflation relative to the 1970's, the credibility that inflation will remain relatively (low with an occasion blip because of oil prices and so on) and relatively stable has been greatly enhanced relative to the 1970's.

We have seen the declines in the discount rate and the Federal funds rate accompanied by falls in long term interest rates. So I think the Fed is able to lower its short term interest rates without increasing inflationary expectations because people do expect that they will not go on an inflation binge as we did in the 1970's.

Money growth has been at the lower end of the Fed's target range for the last couple of years, as a rough approximation, and Chairman Greenspan himself has said that he views this as a serious problem and needs to increase money growth.

Chairman SASSER. That is the reason—all of these things were known. And they were known last summer. That is the reason

some of us were urging the Fed to ease at that time. I think had they eased at that time, we may not have avoided a recession, but I would not be as uneasy and apprehensive about where this recession is taking us as I am now.

Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman, and Mr. Secretary, Dr. Boskin. Good to have you here. The hour is late and I will be very quick.

We heard some interesting comments around the table this morning. I was especially taken by the notion of dynamic estimating. Last year we were told the deficit this year would be $100 billion. Now it is $300 billion. That is dynamic estimating. I for one do not think we need any more of that.

We also heard some comments that increased funding for IRS initiatives probably do not increase revenues, perhaps even make the problem worse. I think the evidence is absolutely overwhelming that that is simply wrong. We have a serious hemorrhage in the revenue system—$100 billion a year. I come to this as a former revenue commissioner and all of the available evidence demonstrates, I think clearly, that there is a significant opportunity that exists in increased enforcement.

I know that the number looks good that we have got in here, but if you get behind the number there is really very little money in here for increased enforcement activity. The California Institute of Technology did a study 2 years ago that indicated that if we had the same level of audit in 1985 that we had in 1978 we would have collected $47 billion more in revenue with no tax increase.

So I hope that you will go back and not be disconcerted by the comments of some that enforcement is not important. I think, to the contrary, we ought to be doing more. There is a significant opportunity that exists.

Finally, just on a point of a question. There have been some comments in the press, specifically a Wall Street Journal story, Secretary Brady, that suggests we are not pushing hard enough on the G–7 with respect to interest rates. This is really a follow-on to the question the chairman asked. Our short term rates now are lower than the other money center banks and we are dependent on $100 billion of imported capital a year.

Is the suggestion that we are not pushing on others to keep their rates down, accurate? Is it unfair criticism? What would your analysis of that be?

Secretary BRADY. Senator Conrad, first of all, as you are, I am sure, well aware that the question of where central bank rates are is a matter over which central bankers have the control, and over which finance ministers do not, for the most part, although it differs country by country. I can assure you that we have raised the question of whether differing, starkly different levels of interest rates in various different countries, does that not produce dislocations. We have put that question hard to the G–7. It has been discussed. It is not a simple question to resolve. But they understand our concerns, I can assure you.

Senator CONRAD. I just want to urge you, as one member of this committee, I think that has got to be very high on our agenda. It concerns me when I see us needing to bring in $100 billion—some-

where in the neighborhood of $10 billion a month. I look at that differential in rates and I wonder how much room there is for us in this current environment. Anything we can do to persuade the other major players that they need to practice some restraint here, I think, may be critically important to our getting through this period with as little damage as possible.

Secretary BRADY. You are right, and of course, the preoccupation now is with Germany where they have raised their rates as we are lowering ours. I would only point out that Japan, which has a bigger economy than Germany, has not moved their rates. So at least in that particular part of the world the same problem does not exist.

Senator CONRAD. Are not their short term rates still better than ours at this point?

Secretary BRADY. They might be marginally better. They certainly—the gap which used to be large between Japanese short-term rates—by that, I mean they were lower than ours—it is now about equal, I think. It goes up and goes down, but we might be slightly lower than theirs due to last week's activities.

Senator CONRAD. Let me just ask one final question directed to Dr. Boskin. I have a group, the Caucus on Deficit Reduction and Economic Growth Group that meets every couple of weeks and last week we heard from Allen Sinai and Dr. Reischauer and the Executive Director of the National Governors Association. They all, looking over the horizon, said it looks to them like we are stuck with a maximum economic growth for the next 5 years of 1 to 2-percent. Do you share that view?

Dr. BOSKIN. No, I do not, Senator. I do believe that the economy will continue to decline for another quarter or two. As we come out of this recession in the second half of the year, growth will be in the 2-percent range. But I do believe that, afterwards, we will be doing better than 2 percent. And I think the economy's long term growth potential is closer to 3 percent than 2 percent.

Senator CONRAD. Thank you. Thank you, Mr. Chairman.

Chairman SASSER. Thank you very much, Senator Conrad. Do you have any further questions, Senator Domenici?

Senator DOMENICI. I did. I have just two and one is by way of an observation.

Chairman SASSER. Could I interrupt you just a moment, if I may?

Senator DOMENICI. Sure.

Chairman SASSER. I have got another pressing engagement which I simply must go to, so I am going to either turn this gavel over to Senator Conrad or Senator Domenici. I want to express my appreciation to Secretary Brady and Dr. Boskin both for appearing here this morning. Their testimony has been very helpful, and the Secretary of the Treasury's testimony has been illuminating as usual. We thank you both for your appearance.

Senator DOMENICI. Mr. Chairman, I am just going to put this one in the record and ask that Dr. Boskin answer it. With regard to foreign holdings of Federal debt—I have a chart that shows a precipitous drop in the percent from 1989 to 1990. I would like an explanation and a prediction, if you would please. That could come from both of you. Why did that happen? I think you have touched on it. Do you think it is going to turn around? And if so, how?

Secretary BRADY. Is it all right if we give the explanation and he gives the prediction?

Senator DOMENICI. Whichever you prefer. Share the burden. I assume you will be consistent since you talk to each other a lot. But I would appreciate that answer.

Dr. Boskin, one question. I believe that science and technology, and the development of technology has become such an integral part of America's future and our standard of living, our productivity, our competitiveness—that it is no longer a microeconomic issue, but a very much part of America's future.

I just want to make a point with you as the adviser to the President, that I believe every chance we get we ought to strengthen research and development and the evolution of technology in this country. The Government has a role, and where the Government can, it should urge it, push it, and pursue it. It is the future.

And I note, the President has done substantially better this year than ever. More research and development in the domestic budget, even with defense coming down: higher research and development activities. I think most people are seeing the effects of past activities, with the war in the Middle East where technology is so important. Many feel that, in the future, with a smaller military we need more, not less, R&D.

I think it is important that not just his science adviser speak to that, but also that the economic adviser from time to time speak to that issue. Could you just comment for a moment?

Dr. BOSKIN. Sure. I could not agree with you more. My own research when I was an academic indicated that a very substantial fraction of the postwar economic growth in the five largest economies: the United States, Japan, Germany, France and the United Kingdom, has indeed come from advances in technology. I often talk to the President about this. I attend the meetings of the President's Council of Advisers on Science and Technology which the Science Adviser chairs. All of his advisers have pushed for increased direct spending. We have, as you noted, proposed in our budget record levels of applied and basic research.

We also have a proposal to make the R&E tax credit permanent, as Secretary Brady said, to enhance private R&D. We also have a concerted effort underway to try to do a better job of getting the applied R&D which is done in Government labs and Government financed, made commercially available to the private sector. So it is an area of considerable concern. We do believe it is very important. I could not agree with you more.

Senator DOMENICI. Thank you very much. I assume we have no further questions. Senator Kasten has asked to insert a statement into the record and without objection we will do so at this point.

[The prepared statement of Senator Kasten follows:]

PREPARED STATEMENT OF SENATOR ROBERT W. KASTEN, JR.

Thank you, Mr. Chairman. I want to commend the President for his leadership in sending to Congress a budget that emphasizes economic growth and empowerment, and recognizes the need to begin limiting the rate of growth in federal spending.

The most discouraging aspect of this budget is that it confirms that the U.S. economy is in recession. This recession, combined with the rapid growth of spending in recent years has resulted in a deficit that is large both in dollar terms and as a

percentage of GNP. More important, the recession means millions of Americans are out of work and businesses are failing.

This makes our mission clear, we must jump start the economy by enacting pro-growth tax cut legislation. The alternative—doing nothing—is unacceptable.

The President has proposed to cut the capital gains tax rate. This will create jobs, stimulate economic growth and improve the competitive position of U.S. companies. Once again there are those who will attempt to inject into this debate the politics of envy. It is these arguments, if they are heeded, that will drag this nation deeper into recession. It is not the rich who lose their jobs in a recession, it is the poor and the middle class.

In addition to reducing the tax on capital, I believe we must reduce the tax on labor. Three quarters of working Americans now pay more in payroll taxes than in income taxes, and most small businesses pay more in payroll taxes than all other taxes combined. A reduction in payroll taxes is consistent with two of the principal themes in the Administration's budget, economic growth and empowerment. After all, what is more empowering than letting working Americans keep more of their paycheck?

I strongly endorse the Administration's empowerment agenda. Enterprise zones have great potential to promote economic development in our inner cities and depressed rural areas. Vouchers and choice in education hold great promise for improving the education of the poor. By the same token, housing vouchers to provide low-income residents more choice will improve the lives of the poor by giving them more power over their future. Education, better housing, and a job in an economy that is healthy and growing can combine to help break the cycle of poverty.

Thank you, I look forward to working with the Administration implement these proposals.

STATEMENT OF SENATOR ROBERT W. KASTEN, JR. ON MODERNIZING FINANCIAL SYSTEM

Yesterday you unveiled a major plan to overhaul the financial industry. The goal as I understand—is to make U.S. banks more competitive and to narrow the safety net of deposit insurance in order to protect taxpayers from paying for costly bank failures. Part of your proposal is to limit the amount of deposit insurance to individuals—$100,000 per individual per bank.

Last year I supported this concept because I felt we needed to reduce the taxpayer's liability and inject some measure of risk on the part of large depositors into the system. Now I've come 180 degrees away from this position. While I still support the concept of eliminating brokered deposits and "bundling" of accounts, reducing the amount of insurance to depositors may undermine confidence in the financial system.

Senator DOMENICI. We stand in recess.

[Whereupon, at 12:43 p.m., the hearing was concluded.]

WRITTEN QUESTIONS FROM SENATOR DOMENICI TO DR. BOSKIN AND THE RESPONSES

Question. Foreigners owned over $400 billion of total debt held by the public in 1990, about 17 percent of the total. How does this share compare with foreign-held debt in the 1970s and 1980s?

Answer. The foreign share of total Federal debt averaged 12.9 percent in the early 1970s and peaked at an average of 17.5 percent in the late 1970s; it reached nearly 20 percent in 1978. Some of the rise in the latter 1970s was due to the issuance of foriegn-denominated Treasury securities (Carter bonds) in late 1978 through the end of 1979. In the early 1980s, the share of Federal debt held by foreigners fell to 15.4 percent, and then rose to an average of 16 percent from 1985 through 1989.

Question. The share of foreign-held debt declined in 1990 from 18 percent of the total in 1989. Do you see a trend here? Do you have an explanation for the decline?

Answer. Although the share of foreign held debt declined between 1989 and 1990, it is common for the share to vary by more than a percentage point from year to year. Thus, it is very difficult to say with any certainty that the decline represents a new trend.

Question. Foreign holdings of Federal debt increased by less than $10 billion last year for the first time since 1982. Since foreign central banks hold two-thirds of Federal debt held by foreigners, do you think a reason for the decline is that foreign banks are purchasing less U.S. debt than in the past?

Answer. According to data available from the Federal Reserve, foreign official institutions decreased their net purchases of marketable U.S. Treasury bonds and notes by about $8 billion in the first 11 months of 1990 compared with the first 11 months of 1989. However, by far the largest swing in foreign purchases occurred in the "other foreign" category, which mainly consists of net purchases by private foreign residents. Thus, most of the change from 1989 to 1990 in purchases of U.S. Treasury instruments appears to reflect private sector behavior.

WRITTEN QUESTIONS FROM SENATOR DOMENICI TO SECRETARY BRADY AND THE RESPONSES

1. Last year's budget agreement mandated that state and local governments collect Social Security taxes where there was not an existing public retirement program. Cities and municipalities are required to begin collecting these taxes on July 1, 1991, but the first phase of issuing Q&A regulations has not begun. Even after the first phase of Q&As is completed, there will still have to be time for issuance of final regulations.

Question. Is the July 1, 1991 deadline going to be met?

Will cities and localities have an adequate amount of time to implement the new law efficiently?

Answer. The July 1 deadline will be met. Regulations are being drafted and Treasury expects to have them published in early April. A revenue ruling may also be issued around the same time providing additional guidance.

Every effort is being made to ensure that cities and localities have sufficient time to implement the new law efficiently.

2. A provision of the 1968 Tax Act deals with arbitrage and rebate requirements enacted on general obligation and revenue bonds. Apparently, revenue is being generated from this provision in excess of what was anticipated.

Questions. How much revenue is being generated from this provision and what was the projected revenue stream?

What effect does this provision have on local infrastructure investments?

If revenues are exceeding estimates, should the requirements be changed, or could the excess revenues be applied to an Infrastructure Trust Fund?

Answer. The Tax Reform Act of 1986 generally extended to all categories of tax-exempt bonds the existing requirement that arbitrage profits from the investment of the proceeds of such bonds be rebated to the federal government. Previously, many state and local governments would overissue bonds or issue bonds earlier than they might otherwise do so in order to earn arbitrage. Imposition of the rebate requirement removes this incentive to overissue or issue early.

The principal revenue effect from this provision is not from collection or arbitrage rebateable rather, it is from the increase in taxable income in the economy due to replacement of the excess volume of tax-exempt bonds with taxable investment instruments. Nevertheless, the federal government does raise revenue from the collection of rebate arbitrage. Although the amount rebated decreased slightly from $17 million in 1987 to $16.2 in 1988, it increased to $22 million in 1989 and to $72 million in 1990. This growth was anticipated and results from a provision enacted in 1986 that requires 90 percent of any rebate to be paid at least once every five years, with the balance to be paid no later than 60 days after retirement of the bonds. The amount of rebate collected should continue to increase at least until the fifth anniversaries begin to occur for bonds issued after 1986.

The legislative history of the 1986 Act indicates that Congress viewed the rebate requirement not as a revenue raising device but rather as a means of excluding arbitrage earnings from the federal tax subsidy otherwise going to tax-exempt bonds. Relaxing or removing the requirement in order to stimulate infrastructure investment would therefore be inconsistent with the policy objectives of the 1986 Act. Moreover, it is not apparent that relaxing the requirement would necessarily benefit infrastructure financing unless strict guidelines were enacted specifically how the arbitrage proceeds were to be spent. A more efficient subsidy, if one were desired, would be to provide a direct subsidy to state and local governments for this type of investment or for the federal government to expend funds directly on infrastructure.

As noted previously, the primary revenue effect of the rebate requirement results from the reduction in the excess volume of tax-exempt securities issued. Since this reduction cannot be measured directly, its revenue effect cannot be measured with any degree of certainty. Therefore, it would be impossible to gauge with certainty the appropriate amount to be deposited in an infrastructure trust fund. Moreover,

deposit of such funds in a trust fund would be burdensome administratively and would necessarily require restrictions on the investment and use of the funds.

3. Last year's reconciliation bill included a 15 percent investment tax credit for Enhanced Oil Recovery. The Secretary of the Treasury was granted the authority to clarify the scope and parameters to eligible recovery methods. Some producers are hesitant to proceed with projects until they know what modifications, if any, the Treasury Department intends to make to the list of qualified technologies.

Questions. It would be very helpful if the Treasury will issue a regulation verifying that the technologies listed in the June, 1979, Department of Energy regulations are eligible for the credit. At a later date, Treasury could add new technologies.

Does the Treasury anticipate any new technologies to the list?

When does the Treasury anticipate issuing the regulations?

Answer. The Treasury Department is currently drafting regulations to implement the new enhanced oil recovery ("EOR") credit, enacted as part of the Omnibus Budget Reconciliation Act of 1990. The regulations will restate the list of qualifying EOR methods that were contained in the 1979 Energy Department regulations, without significant changes in the descriptions of these methods. As directed by the Statement of Managers for the Act, immiscible non-hydrocarbon gas displacement will be added to the list of qualifying methods.

Treasury is also consulting with industry experts to determine whether other methods should be added to the list of qualifying methods. The regulations will contain a procedure for obtaining an IRS ruling or other certification authorizing use of a method not listed on the regulations.

Although it is always difficult to predict with certainty when regulations will be issued, Treasury hopes to publish these regulations in the first half of 1991.

4. How much does the RTC have budgeted for property tax payments in 1991? How much is more than 30 days delinquent? 60 days? 90 days? 180 days?

Answer. The 1991 budget includes $247.5 million for payment of property taxes. The RTC is unable to determine the amount of property taxes that are more than 30 days delinquent, 60 days, 90 days or 180 days. It is the RTC's policy to pay real property tax payments in a timely manner, unless the RTC is abandoning its interest in the property (due to lack of equity) or the RTC is challenging the property's assessed value. (Even in the latter situation, the RTC will pay taxes at the rate it believes is correct until the tax dispute is resolved by the RTC and the local taxing authority.) Undoubtedly, a certain number of tax payments on RTC properties are delinquent. This situation arises from the sheer volume of property involved and the often disordered state of the institution's records when RTC assumes control. As the agency reviews and straightens out a particular property's records and discovers that delinquent taxes exist, these taxes are paid, as appropriate, in accordance with RTC policy.

5. How much does the RTC have budgeted for outside law firms in FY 1991 and FY 1992?

Answer. The RTC receives its legal support from the FDIC. The FDIC budget is based on a calendar year. The budget includes $256.2 million for outside legal services in 1991 and $276.0 million in 1992.

6. The FDIC and RTC are required to pay property taxes on real property to the same extent as other real property. What remedies are available to cities, counties, and state governments where such tax payments are not made?

Answer. Section 219 of FIRREA provides that no property of the RTC shall be subject to levy, attachment, garnishment, foreclosure, or sale without the consent of the Corporation, nor shall any involuntary lien attach to the property of the RTC. Therefore, the RTC will consider any such actions without the consent of RTC as void or unenforceable. However, unless the RTC declines to pay taxes due to a lack of realizable financial interest in the property or is challenging the property's assessment, the full amount of taxes assessed after the date of ownership are to be paid in a timely manner. If any taxes assessed prior to RTC's ownership are unpaid as of the date of RTC ownership, then taxing authorities would be required to file claims with the receivership. Such claims will be paid in accordance with the RTC's claims procedures, and either a full or partial payment may be paid depending upon whether such unpaid taxes are secured or unsecured by a valid lien.

7. There is concern that foreigners are buying up all our assets, including our debt. Treasury estimates that foreign holdings of Federal debt are about one-fifth of the foreign-owned assets in the U.S.

Questions. The share of foreign-held debt declined in 1990 from 18 percent of the total in 1989. Do you see a trend here: Do you have an explanation for the decline?

Foreign holdings of federal debt increased by less that $10 billion last year for the first time since 1982. Since foreign central banks hold two-thirds of federal debt held

by foreigners, do you think a reason for the decline is that foreign central banks are purchasing less U.S. debt than in the past?

Answer. The share of foreign ownership of all Federal debt held outside U.S. government accounts stood at 18.8 percent at the end of FY 1990. Although this is down somewhat from foreigners' 18.0 percent ownership share at end of FY 1989, the 1990 percentage very nearly matches or exceeds comparable foreign ownership shares in the last ten years. Further, as shown in Table C–6 from the President's 1992 Budget, foreign activity in U.S. Treasuries has historically varied widely from year to year.

The Treasury Department welcomes foreign participation in Treasury auctions. Broad participation leads to more cost efficient financing. Furthermore, from the point of view of the U.S. economy, the significant fact is not whether the net capital inflow has been into Treasury securities or into other investments in the U.S. The U.S. economy is borrowing from abroad in order to finance the excess of imports over exports of goods and services. Whether the capital inflow is into Treasury securities or other types of investments, foreigners will have acquired claims on the U.S. economy's future income. If foreign funds do not go into Treasury securities but into other investments, domestic investors will purchase the Treasury issues.

As indicated on the attached tabulation, net new purchases of U.S. Treasury securities by foreign central banks and other official institutions declined in FY 1990 to $1.3 billion from $19.3 billion in FY 1989. However, as these transactions fluctuate from period to period, it would be premature to ascribe the decline to a trend. For instance, in the first quarter of FY 1991 alone, net new foreign official acquisitions of Treasuries rose to $20.8 billion, while there was net disinvestment by all other foreigners of some $1.8 billion.

NEW NEW PURCHASES OF U.S. TREASURY SECURITIES BY FOREIGN CENTRAL BANKS AND OTHER OFFICIAL INSTITUTIONS

[in billions of dollars]

	Amount
Fiscal year:	
1981	7.4
1982	5.9
1983	8.6
1984	8.3
1985	28.0
1987	28.8
1988	43.3
1989	19.3
1990	1.3
1991, Qtr 1	20.8

Source: Treasury International Capital (TIC) Reporting System.

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